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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 674

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER
vs.
SIDNEY S. MUNTER

No. 675

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER
vs.
CARL MUNTER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED NOVEMBER 6, 1946
CERTIORARI GRANTED DECEMBER 16, 1946

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 674

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

SIDNEY S. MUNTER

No. 675

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

CARL MUNTER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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1 In the Tax Court of the United States

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances: For Taxpayer: Samuel Kaufman, Esq. For Comm'r: Orris Bennett, Esq., R. C. Whitley, Esq.

Docket entries

1943

Apr. 5—Petition received and filed. Taxpayer notified. Fee paid.

Apr. 5—Copy of petition served on General Counsel.

Apr. 5—Request for hearing at Pittsburgh, Pa., filed by taxpayer. 4/5/43 Granted.

May 15—Answer filed by General Counsel.

May 19—Copy of answer served on taxpayer (Pittsburgh, Pa.).

1944

Jan. 6—Hearing set February 7, 1944—Pittsburgh, Pa.

Feb. 7—Hearing had before Judge Smith, on Petitioner's motion to continue to next Pittsburgh calendar, motion granted. Motion for continuance filed at hearing.

Feb. 25—Transcript of hearing 2/7/44 filed.

Mar. 7—Hearing set April 24, 1944—Pittsburgh, Pa.

Apr. 4—Motion for continuance to next Pittsburgh, Pa. calendar filed by taxpayer.

Apr. 4—Hearing set April 12, 1944, on motion.

Apr. 4—Copy of motion and notice of hearing served on General Counsel.

Apr. 12—Hearing had before Judge Murdock on petitioner's motion for continuance to Fall calendar.

Apr. 12—Motion of April 4, 1944, for continuance—granted to next Fall calendar. Pittsburgh, Pa.

Sept. 25—Hearing set October 23, 1944—Pittsburgh, Pa.

Oct. 30—Hearing had before Judge Leech on merits. Motion of counsel to consolidate—granted. Stipulation of facts filed. Petitioner's brief due 12/11/44. Petitioner's reply due 1/24/45. Comm'rs brief 1/18/45.

Nov. 30—Motion for extension to Jan. 17, 1945, to file brief, filed by taxpayer. 12/4/44 Granted.

Nov. 27—Transcript of hearing Oct. 30, 1944 filed.

1945

Jan. 19—Brief filed by taxpayer. 1/19/45 Copy served.
Feb. 17—Motion for leave to file the attached brief, brief lodged, filed by General Counsel. 2/19/45 Granted.
May 22—Opinion rendered, Judge Leech. Decision will be entered for the respondent. Copies served.
May 23—Decision entered. Judge Leech, Div. 6.
2 June 8—Petition for review by U. S. Circuit Court of Appeals, 3rd Circuit, filed by taxpayer.
June 8—Designation of contents of record filed by taxpayer.
June 8—Notice of filing petition for review sent to J. P. Wenchel filed.
June 12—Proof of service filed.
June 20—Proof of service of designation of contents of record filed.
July 17—Order extending time for transmission and delivery of the record to August 31, 1945 entered.

3 The Tax Court of the United States

[File endorsement omitted.]

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition

Filed April 5, 1943

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:WPM:NCD-90D) dated January 7, 1943, and as a basis of his proceeding alleges as follows:

1. The petitioner is an individual with residence at 6582 Beacon Street, Pittsburgh, Pennsylvania. The return for the period here involved was filed with the Collector for the 23rd District of Pennsylvania.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A, was mailed to the petitioner on January 7, 1943.

3. The taxes in controversy are income taxes for the calendar year 1940 and in the amount of $9,596.33.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) Increase of salary income in the amount of $2,048.26.

(b) Addition to income of "dividends" received from Crandall, McKenzie & Henderson, Inc., in the amount of $12,500.00.

(c) Increase of income from partnership in the amount of $549.26.

(d) Disallowance of deduction for legal fees in the amount of $4,500.00.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Throughout the year 1940 petitioner and his brother, Carl Munter, were partners engaged in the operation of a laundry business in the City of Pittsburgh, Pennsylvania.

(b) In April, 1940, petitioner and his brother, Carl Munter, acquired by purchase 20,000 shares (a majority) of the capital stock of Crandall, McKenzie & Henderson, Inc., a Pennsylvania corporation, engaged in the dry cleaning business in the City of Pittsburgh, Pennsylvania, and held these shares throughout the remainder of 1940.

(c) Petitioners and his brother, Carl Munter, became officers and employees of Crandall, McKenzie & Henderson, Inc., and in 1940 received compensation for services rendered to the corporation in the respective amounts of $6,000.00 and $3,403.48.

(d) The oral agreement between petitioner and his brother provided that they should be equal partners not only in the conduct of the laundry business, the income from which was reflected on a partnership return, but as to the acquisition, ownership, management and operation of the affairs of Crandall, McKenzie & Henderson, Inc., including the respective salaries received by them from the corporation.

(e) In connection with the purchase of the shares of Crandall, McKenzie & Henderson, Inc., and the borrowing of funds to finance the purchase, legal fees were incurred in 1940 in the amount of $9,000.00.

(f) Subsequent to April, 1940 Crandall, McKenzie & Henderson, which had neither accumulated nor current earnings or profits, distributed to its shareholders cash in the amount of $1.25 per share.

(g) In its fiscal year ended May 31, 1940 the partnership, composed of petitioner and his brother, paid a bonus of $200.00 to one of its employees and distributed among all of its employees Christmas candy costing $353.52, deduction for which was disallowed by the respondent.

Wherefore, the petitioner prays that this Court may hear the proceeding and disallow the deficiency.

Samuel Kaufman,
SAMUEL KAUFMAN,
RUSLANDER AND KAUFMAN,
First National Bank Bldg., Pittsburgh, Pennsylvania.
Counsel for Petitioner.

[*Duly sworn to by Sidney S. Munter; jurat omitted in printing.*]

Exhibit A to petition

TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE.
2300 FARMERS BANK BUILDING.
Pittsburgh, Pennsylvania, January 7, 1943

Office of Internal Revenue Agent in Charge, Pittsburgh Division

IT:WPM.
NCD-90D.

MR. SIDNEY S. MUNTER,
6582 Beacon Street, Pittsburgh, Pennsylvania.

SIR: You are advised that the determination of your income tax liability for the taxable year 1940 discloses a deficiency of $9,596.33 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Pittsburgh, Penna., for the attention of IT:WPM-NCD. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner.
By (Signed) W. P. MAYS.
Internal Revenue Agent in Charge.

Enclosures: Statement. Form of waiver.
NCD:MMM.

TAX LIABILITY FOR THE TAXABLE YEAR ENDED DECEMBER 31, 1940

	Liability	Assessed	Deficiency
Income tax	$19,408.93	$89,812.60	$89,596.33

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated January 15, 1942; to your protest dated June 8, 1942; and to the statements made at the conferences held on August 26, 1942 and December 16, 1942.

A copy of this letter and statement has been mailed to your representative, Mr. Samuel Kaufman, First National Bank Building, Pittsburgh, Pennsylvania, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return		$40,570.14
Unallowable Deductions and Additional Income:		
(a) Salary income increased	$2,048.26	
(b) Dividends increased	12,500.00	
(c) Partnership income increased	549.26	
(d) Legal fees decreased	4,500.00	
		19,597.52
Net income as adjusted		60,167.66

EXPLANATION OF ADJUSTMENTS

(a) It is held that the salary received by you from Crandall, McKenzie & Henderson, Inc. in the year 1940 in the amount of $6,750.00 is taxable to you in its entirety.

Salary reported on your income tax return	$4,701.74
Salary actually received in 1940	6,750.00
Net increase in salary reported	2,048.26

(b) It is also held that dividends received by you from Crandall, McKenzie & Henderson, Inc. in the amount of $12,500.00 in the year 1940 are one hundred percent taxable.

(c) Your share of the net income from the partnership firm of Sweet Clean-Perfect Laundries has been adjusted as follows:

Net income as disclosed by partnership return		$87,500.04
Unallowable deductions and additional income:		
(1) Loss on trade-in decreased	$545.00	
(2) Gifts decreased	553.52	
		1,098.52
Net income of partnership adjusted		88,598.56

Explanation of Adjustments

(1) The loss reported from the exchange of equipment has been disallowed in accordance with the provisions of Section 112 (b)–1, Internal Revenue Code.

Cost of old equipment	$1,800.00
Depreciation allowed	360.00
Depreciated value	1,440.00
Allowance on exchange	885.00
Loss claimed which has been disallowed	555.00

(2) The deduction claimed for gifts made during the year has been disallowed as not being an ordinary and necessary business expense within the provisions of Section 19.23 (a)–1 Internal Revenue Code.

Bonus paid Mr. Logan	$200.00
Candy for employees	353.52
Total	553.52

Your distributive share of the adjusted net income of the partnership is 50 percent or $44,299.28.

(d) It is further held that the amount of $4,500.00 deducted by you in your 1940 income tax return as legal fees represents a personal expenditure which may not be deducted in computing your net income for that year.

11 Computation of Tax

Net income adjusted	$60,167.66
Less: Personal exemption	2,000.00
Balance (surtax net income)	58,167.66
Less: Earned income credit (10% of $14,000.00)	1,400.00
Net income subject to normal tax	56,767.66
Normal tax at 4% on $56,767.66	2,270.71
Surtax on $58,167.66 (Amount in excess of $4,000.00)	15,373.77
Total tax (ordinary)	17,644.48
Defense tax (10% of $17,644.48)	1,764.45
Total income and defense taxes	19,408.93
Corrected tax liability	19,408.93
Income tax assessed: Original, account No. 2040029	9,812.60
Deficiency of income tax	9,596.33

NCD/MMM.

12 In the Tax Court of the United States

[File endorsement omitted]

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Answer

Filed May 15, 1943

Now comes the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition in the above-entitled proceeding admits and denies as follows:

1. Admits the allegations of paragraph 1 of the petition.

2. Admits the allegations of paragraph 2 of the petition.

3. Admits the allegations of paragraph 3 of the petition.

4. (a) Denies the allegations of paragraph 4 (a) of the petition. (b) Denies the allegations of paragraph 4 (b) of the petition. (c) Denies the allegations of paragraph 4 (c) of the petition. (d) Denies the allegations of paragraph 4 (d) of the petition.

5. (a) Admits the allegations of paragraph 5 (a) of the petition.

(b) Admits that in April, 1940, petitioner acquired by purchase shares of the capital stock of Crandall, McKenzie & Henderson, Inc., a Pennsylvania corporation; denies all other allegations of paragraph 5 (b) of the petition.

(c) Admits petitioner became an officer and employee of Crandall, McKenzie & Henderson, Inc., and in 1940 received
13 compensation for services rendered to the corporation; denies the remaining allegations of paragraph 5 (c) of the petition.

(d) Denies the allegations of paragraph 5 (d) of the petition.

(e) Denies the allegations of paragraph 5 (e) of the petition.

(f) Admits that subsequent to April, 1940, Crandall, McKenzie & Henderson, Inc., distributed to its stockholders cash in the amount of $1.25 per share; denies all other allegations of paragraph 5 (f) of the petition.

(g) Denies the allegations of paragraph 5 (g) of the petition.

6. Denies generally each and every allegation of the petition not hereinabove specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petition be denied.

(Signed) J. B. Wenchel,
OB
J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
HARTFORD ALLEN,
Division Counsel,
J. HARRISON MILLER,
Special Attorney,
Bureau of Internal Revenue.
amh: 5/12/43.

14 In the Tax Court of the United States

[File endorsement omitted].

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 1163

CARL MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Stipulation of facts

Filed October 30, 1944

It is hereby stipulated and agreed by and between the parties hereto acting through the undersigned attorneys that for the purpose of trial and decision the following facts are true, without prejudice to the right of either party to introduce other and further evidence not inconsistent therewith.

1. On March 21, 1940 each of the above-named petitioners acquired by purchase at the price of $8.00 per share 10,000 shares of the common stock of Crandall-McKenzie & Henderson, Inc., a

Pennsylvania corporation, out of a total of 38,922 shares of capital stock of said corporation issued and outstanding (exclusive of 11,078 shares of treasury stock) at the price of $8.00 per share under the terms of a written agreement, copy of which is marked Exhibit 1-A and is offered in evidence.

2. On June 19, 1940, Crandall-McKenzie & Henderson, Inc., distributed to its common shareholders cash in the amount of $35,166.25 at the rate of $1.25 per share of which each petitioner received $12,500 with respect to the 10,000 shares held by him.

3. Crandall-McKenzie & Henderson, Inc., at December 31, 1939, had no earnings or profits accumulated from December 4, 1928 to December 31, 1939, and it had no earnings or profits in its taxable year January 1, 1940 to December 31, 1940.

4. Paragraphs 9 to 24, inclusive, of the findings of fact of Schoonmaker, J., in the actions in the District Court of the United States for the Western District of Pennsylvania at Nos. 7085 and 7086 Law, in which Jessie Lee Brown and A. J. Kapp are plaintiffs and D. D. Heiner was defendant are made part of this stipulation, reading as follows:

"9. On November 24, 1928, an agreement was entered into between O. McKenzie and L. Henderson, Jr., of the first part; and K. W. Todd & Company, of the second part, which is shown by Plaintiff's Exhibit I. This exhibit is made a part of these findings of fact.

"The agreement may be summarized as follows:

"Whereas: O. McKenzie owns 842½ shares of stock in Crandall-McKenzie Company, a New Jersey Corporation, which Company has a total authorized capital of $25,000 with 2,060 shares (par $10.00) outstanding.

"Whereas: L. Henderson, Jr., is the owner of, or can deliver, 700 shares (par $100.00) of the capital stock of L. Henderson & Sons, Incorporated, with an outstanding capital stock of 700 shares.

"Whereas: It is desired to consolidate Crandall-McKenzie Company and L. Henderson & Sons Company, Incorporated.

"Now this Agreement: Witnesseth that for and in consideration of mutual covenants herein contained, the parties hereto agree as follows:

"First: The parties of the first part (McKenzie and Henderson) agree to form a new company to be known as Crandall-McKenzie & Henderson, Incorporated (called "new company") with an authorized capital of 100,000 shares of common stock (no par value) of which 50,000 shares shall be immediately issued.

"Second: The party of the second part (K. W. Todd & Company) agrees to buy from said company 28,295 shares of its stock for $544,195.00.

"Third: The parties of the first part (McKenzie and Henderson) agree that they will cause the said corporation to exchange with said O. McKenzie 12,181 shares of its said stock for 842½ shares of the stock of Crandall-McKenzie Company and further agree that they will cause said new company to exchange with L. Henderson, Jr., 9,524 shares of its stock for 700 shares of the stock of L. Henderson & Sons Company, Incorporated.

"Fourth: The parties of the first part (McKenzie and Henderson) agree that they will cause A. E. Crandall to sell to Crandall-McKenzie & Henderson, Incorporated, and will cause Crandall-McKenzie and Henderson, Incorporated, to purchase from A. E. Crandall, 842½ shares of the capital stock of Crandall-McKenzie Company for the sum of $300,000.00 (cash) and that they
17 will cause the other stockholders of Crandall-McKenzie Company to sell to Crandall-McKenzie & Henderson, Incorporated, and will cause said Crandall-McKenzie & Henderson, Incorporated, to buy from the said other stockholders at $315.53 (cash) per share, sufficient stock of said Crandall-McKenzie Company so that together with the stock which it will acquire from the said O. McKenzie and said A. E. Crandall, said Crandall-McKenzie & Henderson, Incorporated, will not own less than 90% of the outstanding stock of said Crandall-McKenzie Company.

"Fifth: That the said Crandall-McKenzie & Henderson, Incorporated, as a stockholder, will cause Crandall-McKenzie Company and L. Henderson & Sons Company, Incorporated, to liquidate and distribute all assets to the new company.

"Sixth: The party of the second part (K. W. Todd & Company) is not obligated to make the purchase of 28,286 shares of the new company unless the parties of the first part carry out the agreements stated above.

"10. At the time of the making of the above agreement on November 24, 1928, the capital stock of L. Henderson and Sons Company, Inc., and of Crandall-McKenzie Company was respectively held as follows:

L. Henderson & Sons, Co., Inc.

L. Henderson, Sr.	532 shares
L. Henderson, Jr.	105 shares
V. E. Martin	10 shares
J. T. Henderson	51 shares
D. Henderson	1 share
T. R. Henderson	1 share
	700 shares

CRANDALL-MCKENZIE COMPANY

O. McKenzie	812½ shares
A. E. Crandall	812½ shares
A. J. Kapp	100 shares
J. L. Brown	100 shares
L. A. Ayers	20 shares
Geo. Hasson	5 shares
104 stockholders	150 shares
	2,000 shares

18 "11. A. E. Crandall noted above as owning 812½ shares of the Crandall-McKenzie Company, opposed the consolidation and would not sell his stock to the new company. Neither would he exchange his stock for stock of the new company. But he did finally sell his 812½ shares to O. McKenzie for $500,000.00 in cash.

"12. After the purchase from A. E. Crandall, the stockholders of Crandall-McKenzie Company were as follows:

O. McKenzie	1,685 shares
A. J. Kapp	100 shares
J. L. Brown	100 shares
L. A. Ayers	20 shares
Geo. Hasson	5 shares
104 stockholders	150 shares
Total	2,060 shares

"13. The new company, Crandall-McKenzie & Henderson, Inc., was organized and charter granted. The first meeting of the stockholders was held on December 4, 1928, at 9:30 A. M. The capital of the new company at this time was $5,000, consisting of 50 shares of a par value of $100 each. 5 shares had been issued to the incorporators. At subsequent meetings of the stockholders and directors held the same day, the capital was increased to $100,000, consisting of 1,000 shares of a par value of $100 each, and then changed to 100,000 shares of no par common with a stated value of $100,000.

"14. At a special meeting held at noon on December 4, 1928, the directors of the new company having been authorized by the stockholders at a meeting held at 11:30 A. M., passed the following resolutions:

"1. That the company purchase from O. McKenzie 1,685 shares of the stock of Crandall-McKenzie Company and pay him therefor $380,000.00 in cash and 12,181 shares of the capital stock of the company.

"2. That the proper officers of the company issue to O. McKenzie in part payment for said stock of Crandall-McKenzie Company, 12,181 fully paid and nonassessable shares of the capital stock of the new company.

"3. That the officers of the company purchase as many of the other shares of Crandall-McKenzie Company as possible, paying therefor $315.53 per share in cash.

19 "4. That 9,524 shares of the capital stock of the new company be issued in payment for 700 shares of the capital stock of L. Henderson & Sons Company, Inc.

"5. That the company sell to K. W. Todd & Company 27,795 shares of the capital stock of the company for $544,195.00, payable in cash.

"15. These resolutions called for the issuance of 49,500 shares of no par common stock of the new company as follows:

Shares to O. McKenzie in part payment of purchase of Crandall-McKenzie Company stock	12,181
Shares to acquire 700 (all) shares of L. Henderson & Sons Company, Incorporated	9,524
Shares sold to K. W. Todd Company	27,795
	49,500
Shares held by incorporators	500
Shares—Total authorized issue	50,000

"16. The agreement outlined above required the acquisition of not less than 90% of the stock of Crandall-McKenzie Company. The 1,685 shares purchased from O. McKenzie (his "original" stock and that which he acquired from A. E. Crandall) constituted less than ninety per cent. But resolution No. "3" gave the directors of the new company power to acquire further shares necessary to make up the ninety per cent. After the above five resolutions were passed, the chairman of the meeting stated that the company could acquire from O. McKenzie and other stockholders (names not mentioned), 1,910 shares of Crandall-McKenzie Company stock. This would mean the acquisition of 225 shares over and above the 1,685 already owned by the new company. These shares were purchased from K. W. Todd & Company at $315.53.

"17. The Board of Directors passed the following resolutions:

"Resolved: That this Company vote its stock of Crandall-McKenzie Company in favor of the dissolution of such company and to that end the proper officers of this company are hereby authorized and directed to execute a proxy for all of the stock of Crandall-McKenzie Company owned by this company to be used at a special meeting of the stockholders of the Crandall-McKenzie Company called for the purpose of approval or disapproval of the dissolution of such company.

20 "Resolved: That this company purchase from the liquidating trustees of Crandall-McKenzie Company all of the assets of Crandall-McKenzie Company, including its real estate plant and equipment, its good will and all of its other personal property and pay for the same the sum of $649,991.80, paying $602,662.30 by the delivery of the 1,910 shares of the capital stock of Crandall-McKenzie stock and the balance, $47,329.50, in cash

upon receipt of proper deeds, bills of sale and other instruments transferring all of said assets to this company.

"18. December 14, 1928, was fixed as the date of completion of all of the above transactions.

"19. At the same meeting, O. McKenzie became president of the new company, and J. L. Brown, treasurer. Other officers and directors were also elected.

"20. On December 5, 1928, the directors of the Crandall-McKenzie Company voted to dissolve and ordered a stockholders' meeting to be held for that purpose on December 17, 1928, in the office of the company at Camden, New Jersey. Subsequently, the directors voted to sell the assets of the company to Crandall-McKenzie & Henderson, Inc., (the new company) for $649,991.80, consisting of 1910 shares of Crandall-McKenzie Company stock and $47,329.50 in cash. The new company was to assume all the liabilities of the old company. All of the cash to be received from the new company was to be distributed to the holders of the remaining outstanding shares of the Crandall-McKenzie Company.

"21. Pursuant to these resolutions the assets and liabilities of Crandall-McKenzie Company were transferred to the new company and the latter surrendered 1910 shares of Crandall-McKenzie stock, and paid $47,329.50 to the Diamond National Bank of Pittsburgh as trustee for the Crandall-McKenzie Company. This $47,329.50 was paid to the remaining stockholders of Crandall-McKenzie Company who owned the remaining 150 outstanding shares.

"22. The stock of L. Henderson & Company was also acquired as called for in the group of five resolutions above set forth (passed at the special meeting of December 4, 1928, supra). That is, the new company issued 9,524 shares of its capital stock in payment for all outstanding shares—700—of the capital stock of L. Henderson & Sons Company, Inc. The latter company then transferred its assets and liabilities in liquidation to the new company and the latter surrendered to L. Henderson & Sons Company the 700 shares capital stock of the latter. This completed the reorganization.

"23. The 100 shares of capital stock of the Crandall-McKenzie Company owned by each plaintiff were transferred by him through K. W. Todd & Company in exchange for 1213 shares of the new company and $15.00 in cash.

"24. The plan of reorganization, as originally adopted, was modified so as to provide for the exchange of the 100 shares of stock owned by each plaintiff in Crandall-McKenzie Company for stock in the new company and each of them became an officer or employee of the new company."

22 5. K. W. Todd & Company was at the times of the foregoing transactions engaged in the investment banking and brokerage business in the City of Pittsburgh, Pennsylvania and purchased the shares of Crandall-McKenzie & Henderson, Inc., in the regular course of business.

6. The 50,000 shares of common stock of Crandall-McKenzie & Henderson, Inc., issued by it in December 1928 were upon consummation of the December, 1928 transactions held by the following persons for the named considerations:

No. of Shares	*Shareholder*	*Consideration*
12,181	O. McKenzie	842½ shares Crandall-McKenzie.
1,213	J. L. Brown	100 shares Crandall-McKenzie.
1,213	A. J. Kapp	100 shares Crandall-McKenzie.
9,524	L. Henderson & Associates	700 shares L. Henderson, Inc.
500	Incorporaters	Cash.
25,369	K. W. Todd & Co.	Cash.
50,000		

7. Crandall-McKenzie & Henderson, Inc., at no time after its organization issued any capital shares other than the 50,000 shares of common stock issued in December 1928 and the stated value of the shares was at all times $1.00 per share.

8. At the time of the transfer of its assets in December 1928 to Crandall-McKenzie & Henderson, Inc., Crandall-McKenzie Company had accumulated earnings or profits of $345,298.49 and
23 at March 1, 1913 it had accumulated earnings or profits of $16,030.54.

9. At the time of the transfer in December 1928 of its assets to Crandall-McKenzie & Henderson, Inc., L. Henderson & Sons, Inc., had accumulated earnings and profits of $74,743.62 which were accumulated after March 1, 1913.

10. From December 4, 1928, the date of its organization, to December 31, 1939 Crandall-McKenzie & Henderson, Inc., had aggregate earnings and profits of $401,470.07, made aggregate cash distributions to shareholders of $369,452.30, and acquired by purchase for cash 11,078 shares $1.00 par value of its own stock for $72,211.13. In 1940 it had a net loss of $37,252.47 and acquired by purchase for cash 12,805 shares $1.00 par value of its own stock for $94,441.90.

11. Petitioner at Docket No. 1162 concedes issues 4 (a) and (d), and petitioner at Docket No. 1163 concedes issue 4 (c).

SAMUEL KAUFMAN,
Counsel for Petitioners.

(Signed) J. P. Wenchel.
JHM
J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue,
Counsel for Respondent.

24 *Joint Exhibit 1–A*

AGREEMENT

Dated March 21, 1940, Between O. McKENZIE and SIDNEY S. and CARL P. MUNTER

25 THIS AGREEMENT

Made this 21st day of March 1940, by and between O. McKenzie, of the City of Pittsburgh in the County of Allegheny in the Commonwealth of Pennsylvania (hereinafter sometimes referred to as "McKenzie"), of the one part and Sidney S. Munter and Carl P. Munter, of the same place (hereinafter sometimes collectively referred to as the "Munters"), of the other part.

Witnesseth that:

1. McKenzie agrees simultaneously with the execution and delivery hereof, to sell and deliver to Munters 20,000 shares of the common stock without par value of Crandall-McKenzie & Henderson, Incorporated, a Pennsylvania corporation (hereinafter sometimes referred to as the "corporation"), owned by McKenzie (being a majority of the shares of stock of the corporation issued and outstanding excluding shares of stock issued and outstanding but owned by the corporation and held in its treasury) at the price of $8.00 per share; and Munters agree to buy all said shares and forthwith to pay the sum of $160,000.00 therefor upon delivery by McKenzie to or to the order of Munters of share certificates evidencing McKenzie's ownership of said shares, properly endorsed and stamped for transfer.

2. Munters agree that they will, on the same basis as to payments in installments and otherwise as is provided in paragraph 5 hereof in respect of minority holders, as therein defined, purchase of McKenzie the remaining 2,491 shares of the
26 common stock of the corporation owned by McKenzie, at the price of $8.00 per share (adjusted by pro rata decrease or increase in the event of the dilution or concentration, respectively, of the equity represented by said shares), and McKenzie agrees to sell said shares to Munters at said price, and on such basis; provided, however, that if the corporation shall, before said purchase and payment in full of the purchase price, make any money distribution to its shareholders (including McKenzie) in respect of its outstanding common shares, Munters shall be entitled to a credit against the price of $8.00 per share (adjusted as aforesaid) equal to the amount per share actually paid to McKenzie in respect of each such share on account of such money distribution.

3. Munters agree that the corporation and/or Munters will, in a manner satisfactory to McKenzie, purchase at the price of $8.00 per share (adjusted as set forth in paragraph 2 hereof) such of the outstanding 16,431 shares of the common stock of the corporation (which 16,431 shares are hereinafter sometimes referred to as "minority shares," and are all the shares of stock of the corporation issued and outstanding after excluding (a) 11,078 shares of the common stock of the corporation issued and outstanding, owned by the corporation and held in its treasury, and (b) the 22,491 shares of said stock owned by McKenzie and referred to in paragraphs 1 and 2 hereof) as may be offered to it by the holders thereof of record as of March 15, 1940, or the heirs, executors, administrators or trustees of any deceased holder of record as of said date; provided, however, that this agreement shall not inure to the benefit of any person in respect of any minority shares of which he became the record holder after March 15, 1940, unless such new record ownership occurred proximately by reason of inheritance, bequest, or distribution from a decedent who was such record holder on or prior to March 15, 1940; and provided further that if the corporation shall, before said purchase or after said purchase but before payment in full of the purchase price, make any money distribution to its shareholders in respect of its outstanding common shares, the corporation and/or Munters shall be entitled to a credit against the price of $8.00 per share (adjusted as aforesaid) equal to the amount per share actually paid to the offering shareholder in respect of the shares offered, on account of such money distribution; and Munters agree that the corporation, or they, will purchase and pay for all such shares as shall be offered to it or them for purchase on terms determined as hereinbelow set forth, by record holders as of March 15, 1940, and heirs, executors, administrators and trustees, as above set forth, and that if the corporation shall for any reason whatsoever not do so, they, Munters, will. In order that this agreement may effectively inure to the benefit of such record holders of said 16,431 shares, their heirs, executors, administrators and trustees (who, including such heirs, executors, administrators, and trustees, are hereinafter sometimes collectively referred to as the "minority holders"), Munters agree that the corporation, or they, will on or before April 15, 1940, send to each of the minority holders, by first-class mail, postage prepaid, addressed to each such holder at his last known address as shown on the records of the corporation, and to the Secretary of the Pittsburgh Stock Exchange for the benefit of all such holders, a written or printed offer, in form satisfactory to McKenzie and sufficient, if and to the extent accepted, as will be specified in the offer, to constitute an obligation legally enforceable by each such minority holder

to the extent of his own interest by action brought either
28 in his own name or in the name of McKenzie to his use, to purchase all or any part of such minority shares at such price, and to pay for same in installments, in amounts, at times, and under terms and conditions, satisfactory to McKenzie, at least one-half of said price to be paid on or before January 1, 1941, and the final installment to be paid not later than January 1, 1942. The agreements by Munters expressed in this paragraph are made by Munters with McKenzie acting as the agent on this behalf of the minority holders, and for and on behalf of such minority holders and for their use and benefit, to the end, understood and intended by Munters, who also intend to be legally bound by the provisions of this paragraph and of said offer, that the same shall constitute an obligation to such of the minority holders as desire to avail themselves of the benefits thereof, legally enforceable by each such minority holder to the extent of his own interest, by action brought either in his own name or in the name of McKenzie to his use.

4. Munters agree that the corporation shall forthwith enter into an agreement with McKenzie whereby

(a) In consideration of an agreement by McKenzie that, for a period of five (5) years from April 1, 1940, or for the remainder of his life (whichever shall be the shorter period) he will, subject to other business and personal demands on his time, act as technical and business consultant for the corporation; provided, however, that nothing herein contained shall oblige McKenzie to be available for consultation at any particular time or times or during any particular part or parts of the period of
29 his said retainer; and provided further that, recognizing the corporation's continued right to the use of its present corporate name, the corporation will use the name "O. McKenzie", or "Orel McKenzie" in advertising and business solicitation and otherwise publicize and make use of McKenzie's connection with the corporation, only in ways and by means in each case submitted to and approved by McKenzie in advance of such use and/or publicity; and

(b) In further consideration of a covenant by McKenzie that he will not, at any place within the Commonwealth of Pennsylvania, directly or indirectly, as sole proprietor, partner, minority or majority stockholder, technical consultant (for any person, firm or corporation other than the corporation), officer, manager, employee, or in any other manner, or to any other extent, engage in the cleaning or dyeing business, or in any kind of business engaged in by the corporation on or prior to July 20, 1939, nor suffer nor permit the use of his name in connection with any such business; provided, however, that he may, without limitation, under

any trade name or corporate title not containing the name "McKenzie", engage in the business of the manufacture and/or sale of materials and supplies of the kinds used by the cleaning and dyeing industry and similar industries, and to the extent by him considered necessary or advantageous, publicize his connection with such business; the corporation will (by an agreement satisfactory to McKenzie in form and authorization) agree to, and will, pay to McKenzie the sum of $45,000.00, payable $9,000.00 on December 31, 1940, and $9,000.00 on December 31st of each year thereafter down to and including December 31, 1944, provided, however, that if McKenzie should die prior to December 31, 1944, all sums thereafter payable hereunder shall be paid by the corporation to McKenzie's estate, as and when said sums shall be due and payable as above specified. McKenzie for his own part agrees that he will enter into the agreement with the corporation contemplated by clause (a) of this paragraph 4, and the covenant contemplated by clause (b) of this paragraph 4, and, for the consideration hereinabove expressed, that he will in good faith perform and comply with said agreement and said covenant, and will act as technical and business consultant at all times when he is available, and that he will not act as technical or business consultant for any person, firm or corporation other than the corporation. Munters agree that the obligation of the corporation to McKenzie under said agreement shall be evidenced and secured by a separate written obligation of the corporation, supported by valid corporate authorization satisfactory to McKenzie, which obligation shall be endorsed or guaranteed by Munters in form satisfactory to McKenzie.

5. All Munter's agreements hereinabove contained for certain covenants, agreements and other things to be made, performed and done by the corporation shall be construed as importing an obligation upon Munters, and Munters hereby oblige themselves, to use every proper and legal means at their disposal, (including without limitation, control by executive management and/or by majority stock ownership in their own names and/or the names of their nominees) to induce the corporation to make, perform and do such covenants, agreements and other things. And Munters hereby agree that if the corporation shall be unable, or shall fail, neglect or refuse, to pay any money, or to agree to do, or to do, any other act or thing, hereinabove stipulated to be paid, or agreed to be done, or done, by the corporation, or shall be restrained from so paying, agreeing or doing, they, Munters, will pay said sum or sums of money, and agree to do, and do, such acts and things, at the respective times hereinabove stipulated as to the corporation, for Munters' own account and at their own expense.

6. All obligations by Munters in this agreement contained or referred to are intended by Munters, and shall be understood and construed to be, the obligations of Sidney S. Munter and Carl P. Munter, jointly and severally. All benefits and obligations conferred and imposed upon the parties hereto, or upon the corporation, by this agreement, or herein referred to, are intended by the parties hereto, and shall be understood and construed to be, conferred and imposed upon the parties hereto and upon the respective heirs, executors and administrators, and, in respect of the corporation, upon the corporation and upon its successors and assigns. Each of the parties to this agreement intends to be legally bound by each and every of the provisions of this agreement.

In witness whereof, the parties hereto have hereunto respectively set their hands and seals, at Pittsburgh, Pennsylvania, the day and year first above written.

Witness:

RALPH D. FRANK [SEAL] O. McKENZIE.
SAMUEL KAUFMAN O. McKENZIE.
of the one part.

DAVID GLICK [SEAL] Sidney S. Munter,
SIDNEY S. MUNTER.

DAVID GLICK [SEAL] Carl P. Munter,
CARL P. MUNTER.
both of the other part.

32 COMMONWEALTH OF PENNSYLVANIA,
County of Allegheny, ss:

On this 21st day of March A. D. 1940, before me, the undersigned authority, came the above named O. McKenzie, and acknowledged the foregoing Agreement to be his act and deed, to the intents and purposes therein expressed.

Witness my hand and notarial seal, the day and year aforesaid.

KATHERINE HARVEY,
Notary Public.

COMMONWEALTH OF PENNSYLVANIA,
County of Allegheny, ss:

On this 21st day of March, A. D. 1940, before me, the undersigned authority, came the above named Sidney S. Munter and Carl P. Munter, and severally acknowledged the foregoing Agreement to be their act and deed, to the intents and purposes therein expressed.

Witness my hand and notarial seal, the day and year aforesaid.

KATHERINE HARVEY,
Notary Public.

33 In the Tax Court of the United States

5 T. C. No. 12

Docket Nos. 1162 1163—Promulgated May 22, 1945

SIDNEY S. MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

CARL MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

C corporation, organized to acquire the assets of corporations A and B, under a plan of reorganization, acquired such assets in December 1928 for 24,131 shares of the capital stock of C and $355,247.75 in cash, which was received by shareholders of A and B in exchange for such stock. The remaining stock of C, constituting more than 50 percent of its entire issued stock, was, under the plan, acquired by new interests for cash in the sum of approximately $486,893.92. Included in the assets acquired from A and B were earnings and profits of those corporations in the sum of $404,011.57 accumulated subsequent to March 1, 1913. In 1940 C distributed to petitioners, as stockholders, cash at the rate of $1.25 per share. As of that date and since its organization C had sustained losses, distributed ordinary dividends, and liquidated or purchased outstanding stock for amounts exceeding the par value of that stock, in such an aggregate sum as to leave an amount in its total earnings and profits for that period
34 insufficient to cover the contested dividends. Held, that the distribution to petitioners in 1940 was from earnings and profits of C and was therefore taxable to petitioners as an ordinary dividend. Commissioner v. Sansome, 60 Fed. (2d) 931; cert. den., 287 U. S. 667.

Samuel Kaufman, Esq., for the petitioners.

Homer F. Benson, Esq., for the respondent.

Opinion

LEECH, Judge: These consolidated proceedings involve deficiencies in income taxes for the calendar year 1940 in the sum of $9,596.33 in the case of petitioner, Sidney S. Munter, and $8,175.50 in the case of petitioner, Carl Munter. The question in each proceeding is whether distributions in the taxable year by Crandall-McKenzie & Henderson, Inc., to the petitioners as stockholders were from earnings accumulated subsequent to March 1, 1913, and

taxable as ordinary dividends, or were returns of capital. The Federal income tax returns of the petitioners for the taxable year were filed with the collector for the 23rd district of Pennsylvania at Pittsburgh, Pennsylvania. The proceedings were submitted upon a formal stipulation of facts which we include herein by reference as our findings of fact.

Briefly stated, the facts are that on March 31, 1940 each of the petitioners, at the price of $8 per share, purchased 10,000 shares of the common stock of Crandall-McKenzie & Henderson, Inc. (hereinafter referred to as "Crandall-McKenzie"), a Pennsylvania corporation, out of a total of 38,922 shares of its capital stock issued and outstanding (exclusive of 11,078 shares of treasury stock). On June 19, 1940, Crandall-McKenzie distributed to its common shareholders cash in the amount of $35,166.25 at the rate of $1.25 per share, of which each petitioner received $12,500 with respect to the 10,000 shares held by him. Crandall-McKenzie, at December 31, 1939, had no earnings or profits accumulated from December 4, 1928, to December 31, 1939, and it had no earnings or profits in the calendar year 1940.

Pursuant to an agreement between K. W. Tood & Company, investment bankers, O. McKenzie and L. Henderson, shareholders of two predecessor corporations, Crandall-McKenzie Company and L. Henderson & Sons, Inc., Crandall-McKenzie had been formed in December 1928 and had acquired all the assets of the two named predecessor corporations in exchange for 24,131 shares of its capital stock and $355,247.75 in cash. This stock and cash were received by stockholders of the two predecessor companies for their stock therein. The remaining 25,869 shares in the new company were issued to new interests for cash in the amount of approximately $486,893.92.

All of the assets of one of the predecessor corporations, L. Henderson & Sons, Inc., were acquired by Crandall-McKenzie solely in exchange for 9524 shares of its stock. At the time of this acquisition L. Henderson & Sons, Inc., had earnings and profits of $74,743.62 accumulated subsequent to March 1, 1913.

The assets of the other predecessor corporation, Crandall-McKenzie Company, were acquired by the new company, Crandall-McKenzie, for 14,607 shares of its stock and $355,247.75 in cash. At the time of this transaction, Crandall-McKenzie Company had earnings and profits accumulated subsequent to March 1, 1913 in the amount of $329,267.95.

O. McKenzie owned 842½ of the outstanding 2,000 shares of stock in Crandall-McKenzie Company, and A. E. Crandall owned the same number of shares. The agreement provided that O. McKenzie and L. Henderson would "cause A. E. Crandall to sell to Crandall-McKenzie * * * [his] 842½ shares.

* * * for * * * $300,000". Crandall refused, however, to go along with the plan or sell to Crandall-McKenzie, but he did sell his stock to O. McKenzie for $300,000. Crandall-McKenzie then purchased, as a block of 1,685 shares, this stock together with the 842½ shares which O. McKenzie owned originally, from O. McKenzie for $300,000 and 12,181 shares of Crandall-McKenzie stock.

From December 4, 1928, the date of its organization, to December 31, 1939, Crandall-McKenzie had aggregate earnings and profits of $401,470.07. During the same period it made aggregate cash distributions of $369,452.30 to shareholders and liquidated or purchased 11,978 shares of its own $1 par value stock for $72,211.13 in cash. In 1940 it had a net loss of $37,252.47 and liquidated or purchased 12,805 shares of its own $1 par value stock for $94,441.90 in cash.[1]

Respondent has treated the distributions to the two petitioners in 1940 as if made from earnings and profits accumulated subsequent to March 1, 1913 and, consequently, taxable as a dividend. The petitioners contend that Crandall-McKenzie, the distributing corporation, at the time of the distributions had no accumulated earnings and profits and that accordingly the distribution was made from capital and not subject to tax. The issue is resolved upon the determination of one question, to wit: whether the distributing corporation, upon its organization in 1928, in the transaction in which it acquired the assets of the two predecessor corporations for stock and cash, took the accumulated earnings and profits of those corporations as its earnings and profits.

In the transaction of December 1928, Crandall-McKenzie, the new company, acquired all the assets of the two predecessor corporations. Stockholders of those two corporations continued as stockholders of the new company and held upwards of 45 per cent of its stock. Under such circumstances we think it is clear that transaction constituted a reorganization under section 112 (i) (1) (A) of the controlling Revenue Act of 1928. Helvering v. Minnesota Tea Co., 296 U. S. 378; John A. Nelson Co. v. Helvering, 296 U. S. 374; Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U. S. 462. In pursuance of the plan, which included that reorganization, the participating stockholders of the old corporations exchanged their stock in the old corporations for stock in the new company and money. These exchanges, therefore, were undoubtedly within the provisions of sections 112 (b) (3) and

[1] Whether the liquidation or purchase of its shares or the net loss did, in fact, reduce earnings and profits available for the payment of the contested dividends we do not consider because, assuming they did not, Crandall-McKenzie did not have enough earnings and profits, earned since its organization, to completely cover the disputed dividends.

112 (c) (1) of the Revenue Act of 1928, as was decided by the United States District Court for the Western District of Pennsylvania in the cases of Brown v. Heiner and Kapp v. Heiner, 15 A. F. T. R. 899. Both parties apparently accept that premise. Respondent argues then that the rules of Commissioner v. Sansome, 60 Fed. (2d) 931; cert. den., 287 U. S. 667, applies
38 and that the earnings and profits of the two predecessor companies retained the status of earnings and profits in the hands of Crandall-McKenzie, the new company.

In the Sansome case the assets of the predecessor corporation were acquired solely for all of the stock in the new corporation which was issued to the stockholders of the old corporation in the same proportions in which they held the stock of the original company. It was there held that the earnings and profits of the old corporation retained the character of earnings and profits in the hands of the new corporation. Petitioners insist that the Sansome rule must be limited to its precise facts, that the situation in connection with the acquisition of the assets of the two predecessor corporations here by Crandall-McKenzie is different from that in the Sansome case in two respects, and that these differences compel the opposite conclusion to that of the court in the Sansome case. Thus petitioners argue (1) that the new capital which came into the new corporation substantially changed the proportionate stockholdings of the old shareholders and thus the identity of the predecessor corporations, and (2) that this new capital was used to acquire a large amount of stock of such corporations at a premium, thus effecting a distribution of the earnings and profits of the predecessor corporations. They rely wholly on Milton Campbell et al. v. United States, 144 Fed. (2d) 177. In that case a successor corporation acquired the business and assets of two pred-
ecessor companies in 1929 in a reorganization under sec-
39 tion 112 (i) (1) (A) of the Revenue Act of 1928, pursuant to which the old stockholders received in exchange stock in the new corporation in a reduced proportional interest and cash, the proceeds of the sale of some of its stock to outsiders by the new corporation.[2] At the time of this reorganization the two predecessor companies had undistributed profits accumulated since February 28, 1913. In 1933 and 1934, the new corporation paid dividends to its preferred stockholders which were substantially more than the earnings of the new company from the date of its incorporation to the date of those distributions. Both of the petitioners were stockholders in the new company, the one having acquired his stock in the 1929 reorganization and the other having

[2] The reorganization in the present case is controlled by the same Revenue Act, to wit: the Revenue Act of 1928.

purchased her stock thereafter. The Circuit Court of Appeals for the Third Circuit, to which this proceeding may be appealed, held that the Sansome rule was not applicable for two reasons: (1)

The identity of proprietary interests which existed in the Sansome case and motivated the court to disregard the corporate entities and treat the earnings of the predecessor corporation as though they were earnings of the successor corporation is, therefore, completely lacking. We think that for this reason alone the doctrine of the Sansome case, which by judicial construction operates to transfer earnings from the corporation which earned them to its successor in reorganization, is inapplicable."

and (2)

"The doctrine of the Sansome case that the accumulated earnings of the predecessor corporation in a tax-free reorganization shall be deemed carried over to the successor corporation for the purpose of distribution to its stockholders as dividends cannot apply to a situation where the accumulated earnings of the predecessor corporation have been distributed to its stockholders at the time of the reorganization. Obviously earnings cannot at one and the same time be distributed to the stockholders of the predecessor corporation and transferred to the successor corporation. We think that in the present cases it must be held that the accumulated earnings of the old Company and of Mulford were distributed to the stockholders of the old companies. Such a conclusion is called for by a provision of the Revenue Act of 1928 which was in force when the reorganization took place.

Section 112 (c) of that Act provided:

"(c) Gain from Exchanges not Solely in Kind. (1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

"(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

As we have already pointed out the reorganization involved the receipt by the stockholders of the Old Company and Mulford of money which under the facts was taxable to them under Section 112 (c). In each case the distribution exceeded the total accumulated earnings of the old companies. If this distribution had "the effect of the distribution of a taxable dividend" within the meaning of paragraph (2) of Section 112 (c) it must be treated as in law a distribution to the stockholders of the entire amount of those earnings.

As we have seen, the accumulated earnings of the Old Company amounted to $2,801,117.15. Since cash in the amount of $9,798,062.50 was distributed to the then common stockholders of the Old Company the distribution was a taxable dividend to the full extent of the accumulated earnings. The same is true of the distribution to the stockholders of Mulford. That company had accumulated earnings of $1,718,397.52 and the distribution amounted to $3,709,003.50 in cash.

Despite the respect in which we hold the Third Circuit Court of Appeals, we think the first reason upon which the Campbell case rests is unsound. See Helen V. Crocker, 29 B. T. A. 773. The identity of the interests of the shareholders of the predecessor corporation in the succeeding company was not, in our opinion, the basis for the decision in the Sansome case. The shareholders of the old corporation received nothing there but stock in the new company. Thus no taxable gain or recognized loss in the reorganization occurred under section 202 (c) (2) of the Revenue Act of 1924, there applicable. That, it seems to us, was the basis for the Sansome rule.

In attacking the validity of this reason supporting the opinion of the majority, in his dissent in the Campbell case Judge Jones said:

In so deciding [the Sansome case], Judge Learned Hand, who spoke for the Court, said (p. 933) that "what was not 'recognized' as a sale or disposition for the purpose of fixing gain or loss [i. e., the reorganization exchange], should [not] be 'recognized' as changing accumulated profits into capital * * *." As it was the intent of Congress, as evidenced by the Revenue Acts, to tax as dividends corporate distributions of earnings accumulated since February 28, 1913, manifestly, to accord such distributions freedom from taxation, when ultimately received by stockholders, merely because of coincidental bookkeeping attendant upon a successor corporation's acquisition of a predecessor's business and assets as the result of a reorganization, would be violative of the Congressional intent. It necessarily followed, therefore, as a corollary, that the nonrecognition of gain or loss allowed by the re-

organization provision there involved (Sec. 202 (c) (2) of
42 the Revenue Act of 1921) should, in the words of Judge Hand, "be read as a gloss upon section 201" (the taxable dividend definition of the Revenue Act of 1921). Accordingly, it was held in the Sansome case (p. 933), as a matter of statutory construction, "that a corporate reorganization which results in no 'gain or loss' under section 202 (c) (2) (42 Stat. 230) does not toll the company's life as continued venture under section 201, and that what were 'earnings or profits' of the original, or subsidiary, company, remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation." The same can be no less true as to a distribution in ordinary course. Sec. 112 (b) and (c) (1) of the Revenue Act of 1928 and Sec. 115 of the Revenue Acts of 1932 and 1934 here involved are substantially the same as the cognate provisions of the Revenue Act of 1921 dealt with in the Sansome case.

We agree with that expression. Compare Commissioner v. Wheeler et al., Exrs., — U. S. —, (Mar. 26, 1945).[3]

As to the second ground for the decision in the Campbell case, assuming it be sound, no basis of fact supporting it exists here. It is obvious, as the Circuit Court recognized in the case, that there could be no distribution having "the effect of the distribution of a taxable dividend" within the meaning of section 112 (c) (2) unless gain to the stockholder receiving that distribution in the exchange was recognizable under section 112 (c) (1).[4]
43 Love v. Commissioner, 113 Fed. (2d) 236; Estate of Edward T. Bedford, 1 T. C. 478; revsd. on another point, 144 Fed. (2d) 272; (cert. granted).

The record in the present case is wholly lacking, at least, in proof of the cost or basis for any of the stock in the predecessor companies in the hands of the exchanging stockholders of those companies. And without that fact there could be no determination of such gain under section 112 (c) (1). This is so unless the acquisition of the Crandall stock is treated as having been purchased by McKenzie for $300,000 and turned over for the same amount to the new corporation in a transaction separate from that involving his original stock—in which event there would have been no gain.

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[3] The Supreme Court there held that, under section 112 (b) (7) of the Revenue Act of 1938, where a corporation disposed of property acquired by it in a nontaxable exchange for its stock, the basis for determining "earnings and profits" available for distribution is the cost of the property to the transferors. Inter alia, the court there said:

"Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income tax liability but shall be taken account of later. §§ 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. Compare Commissioner v. Sansome, 60 F. 2d 931, and see Sen. Rep. No. 2156, 74th Cong., 2d sess., p. 19; H. R. Rep. No. 2894, 76th Cong., 3d sess., p. 41."

[4] In Knapp-Monarch Co., 1 T. C. 59, the fact of gain was apparently assumed, or at least the question was not raised.

Accordingly, we follow the rule announced in the Sansome case [5] and find that the earnings and profits of the predecessor corporations were taken over in toto by Crandall-McKenzie, the successor company. From this conclusion it follows that Crandall-McKenzie had sufficient earnings and profits to cover the distribution in question which was therefore, as the respondent determined, an ordinary dividend as to petitioners and taxable as such.

Reviewed by the Court.

Decisions will be entered for the respondent.

Dissenting opinion

44 DISNEY, J., dissenting: The only question here is whether the corporate distributions to petitioners were from capital or from earnings and profits. The majority opinion relies upon the Sansome case to establish earnings and profits in the distributing corporation. That case was one wherein the court pointed out that there was mere change of stock for assets, without change in proportion of stock holdings, and no other change in the financial structure. The conclusion there reached, that earnings and profits of the old corporation belonged to the new, is by the majority opinion here applied to a situation where more than 50 percent of the capital in the new corporation comes from sources foreign to the old and where, in addition to the exchange of stock for assets, cash is paid as to the predecessor corporation, Crandall-McKenzie, in an amount greater than its accumulated earnings and profits, and somewhat less than the accumulated earnings and profits of both corporations. Such a change in the corporate financial structure seems altogether sufficient to require distinction of the Sansome case. Although that case is based upon denial of the idea that "what was not 'recognized' as a sale or disposition for the purpose of fixing gain or loss should be 'recognized' as changing accumulated profits into capital," it does not seem, under the facts in the instant case that there is any such change; rather, there appears in the majority opinion a conversion of purchased property into earnings and profits. Where, as here, the greater portion of the new company's capital was raised by sale of stock having no
45 connection with the old corporations, there clearly appears difficulty in identifying a later distribution by such new

[5] The rule in the Sansome case has, except for the Crandall case, supra, been followed or approved without qualification in every jurisdiction, so far as we know, in which the question has been raised. Geerday Enterprises, Ltd. v. Commissioner, 128 Fed. (2d) 384; Corrigan v. Commissioner, 103 Fed. (2d) 1010; cert. den., 308 U. S. 576; Baker v. Commissioner, 80 Fed. (2d) 813; Harter v. Helvering, 79 Fed. (2d) 12; Murchison Estate v. Commissioner, 76 Fed. (2d) 641; United States v. Kaufmann, 62 Fed. (2d) 1045; Barnes v. United States, 22 Fed. Supp. 282; Hoyt v. Crocker, supra. See Commissioner v. Wheeler et al., Exrs., supra.

corporation as not out of such new capital, but from the earnings and profits of the old corporation, most particularly where realism seems to require a balancing of cash paid against earnings and profits allegedly acquired. The old stockholders receiving, in addition to stock in the new corporation, large amounts of cash, they seem in fact to have realized upon the earnings and profits of the former corporation to that extent. For the purpose of the present question, the result would not be different if the former corporation kept its earnings and profits, and the new corporation kept its capital in the same amount, in which case later distribution would be pro tanto from such capital.

In my opinion, the record here shows the substance of a distribution of the earnings and profits of the former corporation to its stockholders to the extent that cash paid equaled such earnings and profits, and I do not think that the general idea of nonrecognition of gain or loss in connection with a reorganization should be carried so far as to brand the distributions here as from earnings and profits. Examination of all the cases cited in Campbell v. United States, 144 Fed. (2d) 177, indicates that none involves a situation where new capital is raised by the issuance of new stock and resultant change in proportion of holdings and financial structure. I make no exception of Helen V. Crocker, 29
46 B. T. A. 773, for therein, although the new corporation had authorized capital stock of 10,000,000 shares of $1.00 each, the opening entries on its books showed capital stock of $3,169,266, which is the aggregate par value of the shares issued to the two predecessor corporations. It appears that 900 shares were also issued to the incorporators for cash, but whether these were included in the 3,169,266 shares appears uncertain, and in any event, the number is so small by comparison with the total number issued that I can not consider the case of weight on the present question. The conclusion in Campbell v. United States, supra, is based in part upon the idea that the cash received by the old stockholders had the effect of distribution of a taxable dividend, and so a distribution of the earnings. With that idea we agree in Knapp Monarch Co., 1 T. C. 59, a recapitalization case; also in Estate of Edward T. Bedford, 1 T. C. 478 (also recapitalization). The latter was reversed in Estate of Bedford v. Commissioner, 144 Fed. (2d) 272 (certiorari granted, January 8, 1945), because the Circuit Court considered the distribution, because of earlier stock dividends, to be in partial liquidation. In both cases we emphasized that there were earnings and profits sufficient to cover the distribution. Obviously, then, we considered that the distribution would be from, and reduce, such earnings and profits. Thus it appears that the cash received in addition to stock in reorganiza-

tion does not escape tax, and that therefore the basic thought in the Sansome case, escape from tax because of reorganization-nonrecognition of gain, has no application, so far as
47 concerns any cash also received in addition to stock, by the stockholder—an element altogether foreign to the situation in the Sansome case.

I see no reason to apply that case and would hold that the distribution in 1940 here in question was from capital. I therefore dissent.

48 In the Tax Court of the United States, Washington

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Decision

Pursuant to the determination of the Court, as set forth in its Opinion promulgated May 23, 1945, it is

Ordered and decided: That there is a deficiency in income tax for the calendar year 1940 in the amount of $9,596.33.

(Signed) J. RUSSELL LEECH,
Judge.

Entered May 23, 1945.

49 In the Tax Court of the United States

[File endorsement omitted.]

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for review

Filed June 8, 1945

Sidney S. Munter, the above-named petitioner, a resident of Pittsburgh, Allegheny County, Pennsylvania, hereby petitions

for review by the United States Circuit Court of Appeals for the Third Circuit of the decision entered May 23, 1945, by The Tax Court of the United States determining a deficiency in petitioner's income tax for the calendar year 1940.

SAMUEL KAUFMAN,
522 Oliver Building, Pittsburgh, Pennsylvania,
Attorney for Petitioner.

50 In the United States Circuit Court of Appeals for the Third Circuit

[File endorsements omitted.]

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER ON REVIEW

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT ON REVIEW

Notice of filing petition for review

Filed June 8, 1945

To: J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

You are hereby notified that Sidney S. Munter did, on the 8th day of June 1945, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Third Circuit, of the decision of this Court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this 8th day of June 1945.

B. D. Gamble.
B. D. GAMBLE,
Clerk, the Tax Court of the United States.

Service of copy of petition for review acknowledged this June 9, 1945.

(Signed) J. P. Wenchel.
J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue,
Attorney for Respondent.

51 In the Tax Court of the United States

[File endorsement omitted.]

Docket No. 1162

SIDNEY S. MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Designation of contents of record on review

Filed June 8, 1945

The above-named petitioner hereby designates for inclusion on review the complete record, as follows:

1. The relevant docket entries in The Tax Court.
2. Petition.
3. Answer.
4. Stipulation of Facts and Exhibit.
5. Opinion of The Tax Court.
6. Decision of The Tax Court.
7. Petition for Review.
8. This designation.

SAMUEL KAUFMAN,
Samuel Kaufman,
522 Oliver Building, Pittsburgh, Pennsylvania,
Attorney for Petitioner.

Service of a copy of the within designation is hereby admitted this 20th day of June 1945.

J. P. Wenchel,
J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

52 [Clerks' Certificate to foregoing transcript omitted in printing.]

54 In The Tax Court of the United States

Docket No. 1163

CARL MUNTER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances: For Taxpayer: Samuel Kaufman, Esq., for Comm'r.: R. C. Whitley, Esq., Homer S. Benson, Esq., Orris Bennett, Esq.

Docket entries

1943

Apr. 5—Petition received and filed. Taxpayer notified. Fee paid.

Apr. 5—Copy of petition served on General Counsel.

Apr. 5—Request for hearing at Pittsburgh, Pa., filed by taxpayer. 4/5/43 Granted.

May 15—Answer filed by General Counsel.

May 19—Copy of answer served on taxpayer—Pittsburgh, Pa.

1944

Jan. 6—Hearing set Feb. 7, 1944—Pittsburgh, Pa.

Feb. 7—Hearing had before Judge Smith, on motion of petitioner's counsel to continue to next Pittsburgh calendar. Motion granted.

Feb. 25—Transcript of hearing 2/7/44 filed.

Mar. 7—Hearing set April 24, 1944—Pittsburgh, Pa.

Apr. 4—Motion for continuance to next Pittsburgh, Pa., calendar filed by taxpayer.

Apr. 4—Hearing set April 12, 1944, on motion.

Apr. 4—Copy of motion and notice of hearing served on General Counsel.

Apr. 12—Hearing had before Judge Murdock on petitioner's motion for continuance to Fall calendar.

Apr. 12—Motion of April 4, 1944, for continuance, granted to next Fall calendar. Pittsburgh, Pa.

Sept. 25—Hearing set Oct. 23, 1944—Pittsburgh, Pa.

Oct. 30—Hearing had before Judge Leech on merits. Motion of counsel to consolidate—granted. Stipulation of facts filed. Petitioner's brief due 12/11/44. Petitioner's reply due 1/24/45. Comm'rs. brief 1/18/45.

Nov. 30—Motion for extension to Jan. 17, 1945, to file brief, filed by taxpayer. 12/1/44 granted.

Nov. 27—Transcript of hearing Oct. 30, 1944, filed.

1945

Jan. 19—Brief filed by taxpayer. 1/19/45 Copy served.

Feb. 17—Motion for leave to file the attached brief, brief lodged, filed by General Counsel. 2/19/45 Granted.

May 22—Opinion rendered, Judge Leech. Decision will be entered for the respondent. Copies served.

May 23—Decision entered. Judge Leech, Div. 6.

June 8—Petition for review by U. S. Circuit Court of Appeals, 3rd Circuit, filed by taxpayer.

June 8—Designation of contents of record filed by taxpayer.

June 8—Notice of filing petition for review sent to J. P. Wenchel filed.

June 12—Proof of service filed.
June 20—Proof of service of designation of contents of record filed.
July 17—Order extending time for transmission and delivery of the record to August 31, 1945, entered.

56 In the Tax Court of the United States

[File endorsement omitted.]

Docket No. 1163

CARL MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition

Filed April 5, 1943

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT: WPM NCD-90D) dated January 7, 1943, and as a basis of his proceeding alleges as follows:

1. The petitioner is an individual with residence at 1325 Squirrel Hill Avenue, Pittsburgh, Pennsylvania. The return for the period here involved was filed with the Collector for the 23rd District of Pennsylvania.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A), was mailed to the petitioner on January 7, 1943.

3. The taxes in controversy are income taxes for the calendar year 1940 and in the amount of $8,175.50.

57 4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) Addition to income of "dividends" received from Crandall, McKenzie & Henderson, Inc., in the amount of $12,500.00.

(b) Increase of income from partnership in the amount of $549.26.

(c) Disallowance of deduction for legal fees in the amount of $4,500.00.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Throughout the year 1940 petitioner and his brother, Sidney S. Munter, were partners engaged in the operation of a laundry business in the City of Pittsburgh, Pennsylvania.

(b) In April 1940, petitioner and his brother, Sidney S. Munter, acquired by purchase 20,000 shares (a majority) of the capital stock of Crandall, McKenzie & Henderson, Inc., a Pennsylvania corporation, engaged in the dry cleaning business in the City of Pittsburgh, Pennsylvania, and held these shares throughout the remainder of 1940.

(c) Petitioner and his brother, Sidney S. Munter, became officers and employees of Crandall, McKenzie & Henderson, Inc., and in 1940 received compensation for services rendered to the corporation in the respective amounts of $3,403.48 and $6,000.00.

58 (d) The oral agreement between petitioner and his brother provided that they should be equal partners not only in the conduct of the laundry business, the income from which was reflected on a partnership return, but as to the acquisition, ownership, management and operation of the affairs of Crandall, McKenzie & Henderson, Inc., including the respective salaries received by them from the corporation.

(e) In connection with the purchase of the shares of Crandall, McKenzie & Henderson, Inc., and the borrowing of funds to finance the purchase, legal fees were incurred in 1940 in the amount of $9,000.00.

(f) Subsequent to April 1940 Crandall, McKenzie & Henderson, which had neither accumulated nor current earnings or profits, distributed to its shareholders cash in the amount of $1.25 per share.

(g) In its fiscal year ended May 31, 1940, the partnership, composed of petitioner and his brother, paid a bonus of $200.00 to one of its employees and distributed among all of its employees Christmas candy costing $353.52, deduction for which was disallowed by the respondent.

WHEREFORE, the petitioner prays that this Court may hear the proceeding and disallow the deficiency.

Samuel Kaufman,
SAMUEL KAUFMAN,
RUSLANDER AND KAUFMAN,
First National Bank Bldg., Pittsburgh, Pennsylvania,
Counsel for Petitioner.

59 [*Duly sworn to by Carl P. Munter; jurat omitted in printing.*]

60 *Exhibit A to petition*

TREASURY DEPARTMENT

INTERNAL REVENUE SERVICE,
2300 FARMERS BANK BUILDING,
Pittsburgh, Pennsylvania, January 7, 1943.

Office of Internal Revenue Agent in Charge, Pittsburgh Division
IT:WPM.
NCD-90D.

MR. CARL MUNTER,
5562 Hobart Street, Pittsburgh, Pennsylvania.

SIR: You are advised that the determination of your income tax liability for the taxable year 1940 discloses a deficiency of $8,175.50 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Pittsburgh, Penna., for the attention of IT:WPM-NCD. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner.

By (Signed) W. P. MAYS,
Internal Revenue Agent in Charge.

Enclosures: Statement
Form of waiver.
NCD-MMM.

61 TAX LIABILITY FOR THE TAXABLE YEAR ENDED DECEMBER 31, 1940

	Liability	*Assessed*	*Deficiency*
Income tax	$8,114.36	$9,938.86	$8,175.50

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated January 15, 1942; to your protest dated June 9, 1942; and

to the statements made at the conferences held on August 26, 1942 and December 16, 1942.

A copy of this letter and statement has been mailed to your representative, Mr. Samuel Kaufman, First National Bank Building, Pittsburgh, Pennsylvania, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return		$40,857.64
Unallowable Deductions and Additional Income:		
(a) Dividends increased	$12,500.00	
(b) Partnership income increased	549.26	
(c) Legal fees decreased	4,500.00	
		17,549.26
Total		58,406.90
Nontaxable Income and Additional Deductions:		
(d) Salary income decreased		801.41
Net income as adjusted		57,605.49

EXPLANATION OF ADJUSTMENTS

(a) It is held that dividends received by you from Crandell, McKenzie & Henderson, Inc. in the amount of $12,500.00 in the year 1940 are one hundred percent taxable.

62 (b) Your share of the net income from the partnership firm of Sweet Clean-Perfect Laundries has been adjusted as follows:

Net income as disclosed by partnership return		$87,700.04
Unallowable deductions and additional income:		
(1) Loss on trade-in decrease	$545.00	
(2) Gifts decreased	553.52	
		1,098.52
Net income of partnership adjusted		88,598.56

EXPLANATION OF ADJUSTMENTS

(1) The loss reported from the exchange of equipment has been disallowed in accordance with the provisions of Section 112 (b) 1 Internal Revenue Code.

Cost of old equipment	$1,800.00
Depreciation allowed	360.00
Depreciation value	1,440.00
Allowance in exchange	895.00
Loss claimed which has been disallowed	545.00

(2) The deduction claimed for gifts made during the year has been disallowed as not being an ordinary and necessary business

expense within the provisions of Section 19.23 (a)–1 Internal Revenue Code.

Bonus paid Mr. Logan	$200.00
Candy for employees	353.52
Total	553.52

Your distributive share of the adjusted net income of the partnership is 50 percent or $44,299.28.

(c) It is held that the amount of $4,500.00 deducted by you in your 1940 income tax return as legal fees represents a personal expenditure which may not be deducted in computing your net income for that year.

(d) It is further held that the salary received by you from Crandall, McKenzie & Henderson, Inc., in the year 1940 is the amount of $3,900.33 is taxable to you in its entirety.

Salary reported on your income tax return	$4,701.74
Salary actually received during 1940	3,900.33
Net decrease allowed	801.41

The credit claimed on your income tax return for personal exemption in the amount of $2,000.00 has been decreased by $10.00, inasmuch as you were not married until February 11, 1940.

This adjustment is in accordance with the provisions of Section 19.25 (b)–3 Internal Revenue Code.

Married exemption 11/12 of $2,000.00	$1,833.33
Single exemption 1/12 of $800.00	66.67
Adjusted exemption	1,900.00

COMPUTATION OF TAX

Net income adjusted	$57,605.49
Less: Personal exemption	1,900.00
Balance (surtax net income)	55,705.49
Less: Earned income credit (10% of $12,700.19)	1,276.02
Net income subject to normal tax	54,429.47
Normal tax at 4% on $54,429.47	2,177.18
Surtax on $55,705.49 (Amount in excess of $4,000.00)	14,290.42
Total tax (ordinary)	16,467.60
Defense tax (10% of $16,467.60)	1,646.76
Total income and defense taxes	18,114.36
Corrected tax liability	18,114.36
Income tax assessed: Original, account No. 204700	9,938.86
Deficiency of income tax	8,175.50

NCD/MMM

64 In the Tax Court of the United States

[File endorsement omitted.]

Docket No. 1163

CARL MUNTER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Answer

Filed May 15, 1943

NOW comes the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition in the above-entitled proceeding admits and denies as follows:

1. Admits the allegations of paragraph 1 of the petition.

2. Admits the allegations of paragraph 2 of the petition.

3. Admits the allegations of paragraph 3 of the petition.

4. (a) Denies the allegations of paragraph 4 (a) of the petition. (b) Denies the allegations of paragraph 4 (b) of the petition. (c) Denies the allegations of paragraph 4 (c) of the petition.

5. (a) Admits the allegations of paragraph 5 (a) of the petition.

(b) Admits that in 1940 petitioner acquired by purchase shares of the capital stock of Crandall, McKenzie & Henderson, Inc., a Pennsylvania corporation; denies all other allegations of paragraph 5 (b) of the petition.

(c) Admits petitioner became an officer and employee of Crandall, McKenzie & Henderson, Inc., and in 1940 received compensation for services rendered to the corporation; denies the remaining allegations of paragraph 5 (c) of the petition.

65 (d) Denies the allegations of paragraph 5 (d) of the petition.

(e) Denies the allegations of paragraph 5 (e) of the petition.

(f) Admits that subsequent to April 1940, Crandall, McKenzie & Henderson, Inc., distributed to its stockholders cash in the amount of $1.25 per share; denies all other allegations of paragraph 5 (f) of the petition.

(g) Denies the allegations of paragraph 5 (g) of the petition.

6. Denies generally each and every allegation of the petition not hereinabove specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petition be denied.

(Signed) J. P. Wenchel,
OB
J. P. Wenchel,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
Hartford Allen,
Division Counsel,
J. Harrison Miller,
Special Attorney,
Bureau of Internal Revenue.
amh: 5/12/43.

66 In the Tax Court of the United States, Washington

Docket No. 1163

Carl Munter, petitioner

v.

Commissioner of Internal Revenue, respondent

Decision

Pursuant to the determination of the Court, as set forth in its Opinion promulgated May 22, 1945, it is

Ordered and decided: That there is a deficiency in income tax for the calendar year 1940 in the amount of $8,175.50.

(Signed) J. Russell Leech,
Judge.

Entered May 23, 1945.

67 In the Tax Court of the United States

[File endorsement omitted.]

Docket No. 1163

Carl Munter, petitioner

v.

Commissioner of Internal Revenue, respondent

Petition for review

Filed June 8, 1945

Carl Munter, the above-named petitioner, a resident of Pittsburgh, Allegheny County, Pennsylvania, hereby petitions for

review by the United States Circuit Court of Appeals for the Third Circuit of the decision entered May 23, 1945, by The Tax Court of the United States determining a deficiency in petitioner's income tax for the calendar year 1940.

SAMUEL KAUFMAN,
522 Oliver Building, Pittsburgh, Pennsylvania,
Attorney for Petitioner.

68 In the United States Circuit Court of Appeals for the Third Circuit

[File endorsements omitted.]

Docket No. 1163

CARL MUNTER, PETITIONER ON REVIEW

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT ON REVIEW

Notice of filing petition for review

Filed June 8, 1945

To J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

Your are hereby notified that Carl Munter did, on the 8th day of June 1945, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Third Circuit, of the decision of this Court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this 8th day of June 1945.

B. D. Gamble.
B. D. GAMBLE,
Clerk, the Tax Court of the United States.

Service of copy of petition for review acknowledged this June 9, 1945.

(Signed) J. P. Wenchel.
J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue,
Attorney for Respondent.

69 United States Circuit Court of Appeals for the Third Circuit

No. 9010—October Term, 1945

SIDNEY S. MUNTER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

No. 9011—October Term, 1945

CARL MUNTER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petitions for Review of the Decisions of the Tax Court of the United States

Argued November 20, 1945

Before BIGGS, McLAUGHLIN and O'CONNELL, Circuit Judges

Opinion of the court

Filed August 7, 1946

By McLAUGHLIN, Circuit Judge.

On March 21, 1940, the petitioners each purchased from O. McKenzie 10,000 shares of the common stock of Crandall-McKenzie & Henderson, Inc., a Pennsylvania corporation, paying therefor $8.00 per share. The total outstanding capital stock of the corporation at the time was 38,922 shares, exclusive of 11,078 shares of treasury stock. On June 19, 1940, the corporation distributed to its common stockholders cash in the amount of $35,466.25 at the rate of $1.25 a share of which each petitioner received $12,500 with respect to the 10,000 shares held by him. These sums were held by the Commissioner to be taxable to the petitioners as an ordinary dividend. The Tax Court sustained the Commissioner.

In 1928, under an agreement with investment bankers, two corporations, Crandall-McKenzie Co. and L. Henderson & Sons, Inc., were reorganized into the above-mentioned Crandall-McKenzie & Henderson, Inc. At the end of the process, old company stockholders held 45% of the stock of the new corporation.

70 Over half of the 50,000 shares issued were purchased by new investors for approximately $486,875.92. The stockholders

of Crandall-McKenzie Co. received 14,607 shares and $355,247.75 for the shares (par value $10) and upon dissolution, the assets of that concern.[1] The shares and assets of L. Henderson & Sons, Inc., were acquired solely for 9,524 shares of the new corporation. At the time, Crandall-McKenzie Co. had earnings and profits accumulated subsequent to March 1, 1913, of $329,267.95 and L. Henderson & Sons, Inc., had similar earnings and profits of $74,743.62, making a total of $404,011.57 earnings and profits taken over by the successor corporation.[2] From the date of the organization until the end of 1939, the new company had aggregate earnings and profits of $401,470.07. During that period it made cash distributions of $369,452.30 to shareholders and liquidated or purchased 11,078 of its own ($1 par value) stock for $72,211.13 cash. In 1940 it had a net loss of $37,252.47 and liquidated or purchased 12,805 shares of its own stock for $94,141.90 in cash.[3] Also in 1940 it made the distribution on which the tax in question was levied.[4]

We agree with the Tax Court that the acquisition of all of the assets of the two old companies by Crandall-McKenzie & Henderson, Inc., constituted a reorganization under Section 112 (i). (1) (A) of the applicable Revenue Act of 1928. Petitioners' argument though not so conceding assumes this to be so.

The Tax Court held that the earnings and profits of the two old corporations amounting to $404,011.57 were taken over by the successor company. From this it concluded that the latter had sufficient earnings to cover its 1940 distribution which therefore was an ordinary dividend as to petitioners and taxable as such. In so doing it relied chiefly upon Commissioner vs. Sansome, 60 F. 2d 931 (C. C. A. 2), certiorari denied, Sansome vs. Burnet, 287 U. S. 667. In that case the stock of a new corporation was exchanged for the assets of its predecessor without change in proportion of stockholdings and no other change in the financial structure. The Court decided that in such situation the earn-

[1] This transaction was in itself a series of purchases and exchanges between various stockholders. One of the leading old holders, apparently unfavorable to the plan, had to be bought out by another holder, O. McKenzie. The first sold 842½ old shares to McKenzie for $300,000. The new company then bought them for the same price and gave McKenzie 12,181 shares for 842½ shares of his own old stock.

[2] No purpose would be served by attempting to treat these sums separately. The circumstances that no cash was given in return for the L. Henderson profits does not justify such separate treatment, especially since Section 112 (e) of the Revenue Act of 1928, involved in the holding below, does not enter into our decision. When and if these sums were paid out later as dividends their detailed source would be immaterial. Section 115 (b) I. R. C.; Helen vs. Crocker, 29 B. T. A. 777. The reorganization being a single transaction (Starr vs. Commissioner, 82 F. 2d 964 (C. C. A. 4)), only the total earnings and profits arrived at upon its conclusion appears pertinent.

[3] The Tax Court did not determine whether the sums expended in liquidating purchases should be subtracted from accumulated earnings and profits. This was unnecessary to the decision below and is not important to the result arrived at here.

ings and profits of the old corporation were later so taxable
71 upon distribution to the successor company in the form of dividends.[4] That rule is now well settled tax law.[4] It was discussed at length by Judge Maris for this Court in Campbell vs. United States, 144 F. 2d 177. There the plaintiff and other stockholders who paid cash for their shares came into the corporate set-up as a result of the reorganization, and the proportionate ownership of the stockholders of the two old companies in the successor corporation was reduced to a fraction of their interest in the former companies. In stating the first of the two reasons which distinguished the Campbell facts from Sansome vs. Commissioner,[5] Judge Maris said, at page 180:

"The identity of proprietary interest which existed in the Sansome case and motivated the court to disregard the corporate entities and treat the earnings of the predecessor corporation as though they were earnings of the successor corporation is, therefore, completely lacking. We think that for this reason alone the doctrine of the Sansome case, which by judicial construction operates to transfer earnings from the corporation which earned them to its successor in reorganization, is inapplicable."

On the same point with reference to the extension of the Sansome rule the Court further said:

"We are aware that it has also been applied to transfers of corporate assets which, while constituting tax-free reorganizations within the meaning of the revenue act, none the less involved the introduction of new capital and new stockholders into the corporate picture with consequent changes in the proportionate interests of the old stockholders in the enterprise. We cannot accede to such an extension of the Sansome doctrine, however, because it involves the contradictory concept of a corporation buying profits with money contributed by new stockholders, whereas profits by their nature must be realized from other transactions and may not themselves be acquired by purchase."

In the present matter new interests having no connection with the predecessor companies paid at least $486,893.92 cash for over 50% of the capital stock of Crandall-McKenzie & Henderson, Inc.

---

[4] Corrigan vs. Commissioner, 103 F. 2d 1019 (C. C. A. 3); certiorari denied, 308 U. S. 576, decided on the authority of Baker vs. Commissioner, 80 F. 2d 843 (C. C. A. 2); Gourley Enterprises vs. Commissioner, 126 F. 2d 384 (C. C. A. 4); Murchesons Estate vs. Commissioner, 76 F. 2d 643 (C. C. A. 5); United States vs. Kaufman, 62 F. 2d 1047 (C. C. A. 9).

[5] Since this case is squarely under the first exception in Campbell it is sufficient for the purposes of this opinion to simply state the second exception as set out in the Campbell opinion, page 181:

"The doctrine of the Sansome case that the accumulated earnings of the predecessor corporation in a tax free reorganization shall be deemed carried over to the successor corporation for the purpose of distribution to its stockholders as dividends cannot apply to a situation where the accumulated earnings of the predecessor corporation have been distributed to its stockholders at the time of the reorganization. Obviously earnings cannot at one and the same time be distributed to the stockholders of the predecessor corporation and transferred to the successor corporation."

Of that sum, $355,247.75 was paid in addition to stock, for
72 the old Crandall-McKenzie assets. The earnings of that concern amounted to $329,267.95. The L. Henderson & Sons, Inc., earnings totaled $74,743.62. As seen the new corporation not only differed radically from its two predecessors but actually paid out in cash to one of them more than the latter's earnings and profits though less than the combined earnings and profits of both old corporations. The Tax Court recognizes that the facts are directly within the first branch of the Campbell decision but contends for the general application of the Sansome principle. It cites Helen vs. Crockett, 29 B. T. A. 773, but in that matter the new corporation seems to have exchanged its stock substantially share for share with that of its predecessor corporation. The only other cases cited where the successor company is said to have new stockholders are Putnam vs. United States, 149 F. 2d 721 (C. C. A. 1) and Reed Drug Co. vs. Commissioner, 130 F. 2d 288 (C. C. A. 6). Both of these are readily distinguishable from the instant problem. In Putnam the acquiring corporation was already established, there was not cash involved in the obtaining of the stock, and the "proportionate proprietary interest" of the owners of the corporation and partnership taken over was "maintained". In Reed the new company was formed to absorb the old concern and several other corporations in the same business. The old corporation exchanged its assets for stock in the new, there was no cash in the transaction nor does it appear that the proportionate proprietary interest of the old company stockholders was disturbed.

We think this reorganization is entitled to be judged on its own particular facts. In none of the decisions extending the Sansome doctrine do we find the situation that appears in Campbell vs. United States and in the pending issue. The Campbell opinion is still the law of this Circuit. It controls the question under consideration. The finding below is directly contrary to it and therefore must be reversed.

Dissenting opinion

O'CONNELL, Circuit Judge, dissenting.

I cannot concur in the conclusions reached by the majority. Since a reversal of the Tax Court's rulings is placed squarely on Campbell vs. United States, 144 F. 2d 177 (C. C. A. 3, 1944), consideration of that case is required.

As I understand the Campbell case, this court, per Judge Maris, found two reasons why the undistributed earnings of a corporation were not transferred over for tax purposes to a successor corporation in a tax-free reorganization. The first was that "The

identity of proprietary interests which existed in the Sansome case" was lacking in the Campbell reorganization. The second was "the accumulated earnings of the predecessor corpora-
73 tion have been distributed to its stockholders at the time of the reorganization." Campbell vs. United States, supra, 144 F. 2d at 180, 181. There were thus alternative bases for the Campbell ruling.

Acquiescing in principle in the second basis for that decision, I am compelled to disagree with the first, if it was meant to be laid down as a criterion to be applied in other cases. Stripping aside the language necessary for the solution of the perplexing problem of statutory construction in the Sansome case, I believe that the real basis for that ruling is the prevention of tax evasion. See Putnam vs. United States, 149 F. 2d 721, 726 (C. C. A. 1, 1945). By judicial interpretation, later sanctioned by Congress (see S. Rep. No. 2156, 74th Cong., 2d Session, p. 19 (1939–1 Cum. Bull. (Part 2) 678–690)), the general rule has evolved that where one corporation acquires all the assets and assumes all the existing obligations of another corporation in a tax free reorganization, the undistributed earned surplus of the transferor becomes the undistributed earned surplus of the transferee and is subject to taxation as a dividend on subsequent distribution to the stockholders of the transferee. The factor of vital importance in the application of this general rule is the distribution of earned corporate surplus which had not previously been distributed. Such earnings do not disappear, and the rule of Sansome which has been "adopted in this circuit and has been followed in every circuit in which the question has been determined," Campbell v. United States, supra, 144 F. 2d at p. 179, has laid to rest the question of capitalization of accumulated earnings through the device of reorganization. Identity of the distributee is no more material than identity of the distributor. Any distribution made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, is a dividend. Section 115 (a), Internal Revenue Code.[2] Gross income includes income from dividends. Section 22 (a), Internal Revenue Code.[3] We have long since passed the stage where taxability of dividends distributed to those who became shareholders after the corporate earnings or profits came into existence is even questioned. See United States v. Phellis, 257 U. S. 156, 171–172 (1921); Taft v. Bowers, 278 U. S. 470, 484 (1929). Thus, that the profits had already been earned when petitioners purchased their shares in 1940 is immaterial. Cf. Commissioner v. Sansome, 60 F. 2d 931, 932: "Under the Sansome rule, earnings or profits which pass

[2] 26 U. S. C. A. § 115 (a).
[3] 26 U. S. C. A. § 22 (a).

to a successor company are taxable as dividends on subsequent distribution. It does not matter who received them": Putnam v. United States, supra, 149 F. 2d at p. 727.

74 In my view this case narrows down to this: Two companies (one will be referred to herein as "Crandall" and the other as "Henderson") are reorganized into a third (called the "New Corporation" herein), with the reorganization resulting in a possibly recognizable distribution of Crandall's earnings but with no distribution whatsoever of Henderson's earnings. None of the $355,247.75 in cash which passed in this transaction came out of Henderson's earnings. Indeed, the Tax Court found that all of the assets of Henderson were acquired by the New Corporation solely in exchange for 9.524 shares of its stock. The Tax Court also found that at the time of this acquisition, Henderson had earnings and profits of $74,743.62 accumulated subsequent to March 1, 1913.

On March 21, 1940, the petitioners purchased their shares in the New Corporation. On June 19, 1940, the New Corporation distributed to its common shareholders cash in the amount of $85,166.25, of which petitioners received $25,000 between them. Whether the accumulated earnings (without regard to the earnings of Crandall, but including the earnings of Henderson), considering the Treasury Stock purchased and held and the possibility of loss up to June 1940 (the company's loss for the year 1940 was $37,252.47), were sufficient to cover such distribution is for determination by the trier of the facts. If so found, it follows that what the petitioners received was dividends in accordance with the Sansome doctrine. Cf. Campbell v. United States, supra, Judge Jones' dissent, 144 F. 2d at p. 184.

Accordingly, I should reverse and remand to the Tax Court for such determination.

In the United States Circuit Court of Appeals for the Third Circuit

No. 9010—October Term, 1945

SIDNEY S. MUNTER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Judgment

Present: BIGGS, McLAUGHLIN, and O'CONNELL, Circuit Judges.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

75. On consideration whereof, it is now here ordered, adjudged, and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby reversed.

By the Court.

McLAUGHLIN,
Circuit Judge.

AUGUST 7, 1946.

Endorsements.

(Order Reversing Decision of Tax Court. Received & Filed, August 7, 1946. William P. Rowland, Clerk.)

In the United States Circuit Court of Appeals for the Third Circuit

No. 9011—October Term, 1945

CARL MUNTER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Judgment

PRESENT: BIGGS, McLAUGHLIN, and O'CONNELL, Circuit Judges.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged, and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby reversed.

By the Court.

McLAUGHLIN,
Circuit Judge.

AUGUST 7, 1946.

Endorsements.

(Order Reversing Decision of Tax Court. Received & Filed, August 7, 1946. William P. Rowland, Clerk.)

[Clerk's Certificate to foregoing transcript omitted in printing.]

76 In the Supreme Court of the United States

October Term, 1946

Nos. — and —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

Stipulation

Subject to the approval of this Honorable Court, it is hereby stipulated and agreed by and between the attorneys for the parties in the above-entitled causes that, for the purpose of the petition for writs of certiorari, the printed record may consist of the following:

1. The appendix to the brief for the petitioners in the United States Circuit Court of Appeals for the Third Circuit.

2. The proceedings before the United States Circuit Court of Appeals for the Third Circuit.

It is further stipulated and agreed that the petitioner will file the entire transcript of the record now on file in the office of the Clerk of the United States Circuit Court of Appeals for the Third Circuit with the Clerk of the United States Supreme Court, and that in the event the petition for writs of certiorari is granted the printed record shall consist of the proceedings in the court below and such portions of the entire transcript of the record certified by the Clerk of the United States Circuit Court of Appeals for the Third Circuit as the respective parties may designate. It is further agreed that either party may, in the

77 petition and briefs, refer to any portions of the typewritten transcript of record which is not included in the printed record filed with this Court.

J. Howard McGrath,
J. HOWARD MCGRATH,
Solicitor General,
Counsel for Petitioner.

SAMUEL KAUFMAN,
Counsel for Respondents.

Dated this 29 Day of October 1946.

78 Supreme Court of the United States

No. 674, October Term, 1946

Order allowing certiorari

Filed December 16, 1946

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

79 Supreme Court of the United States

No. 675, October Term, 1946

Order allowing certiorari

Filed December 16, 1946

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

80 In the Supreme Court of the United States

October Term, 1946

No. 674

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER, RESPONDENT

No. 675

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER, RESPONDENT

Stipulation

Filed February 7, 1947

Subject to this Court's approval, it is hereby stipulated and agreed by and between the attorneys for the respective parties

hereto, that for the consideration of this case on the writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit, granted December 16, 1946, the printed record may consist of the following:

1. Transcript of all proceedings in the Tax Court in Sidney S. Munter v. Commissioner of Internal Revenue (Tax Court Docket No. 1162).

2. All proceedings in the Circuit Court of Appeals for the Third Circuit covering both cases.

3. Docket entries in Carl Munter v. Commissioner of Internal Revenue (Tax Court Docket No. 1163).

4. Taxpayer's petition for redetermination the Tax Court, with notice of deficiency by Commissioner attached, in Carl Munter v. Commissioner of Internal Revenue (Tax Court Docket No. 1163).

5. Commissioner's answer in the Tax Court in Carl Munter v. Commissioner of Internal Revenue (Tax Court Docket No. 1163).

6. Petition for review by the Circuit of Appeals for the Third Circuit and notice of service, in Carl Munter v. Commissioner of Internal Revenue (Tax Court Docket No. 1163).

7. This stipulation.

It is further agreed that in the briefs for either party reference may be made to any portion of the transcript of record which is not included in the printed record prepared as aforesaid.

George T. Washington,
GEORGE T. WASHINGTON,
Acting Solicitor General,
Attorney for Petitioner.

Dated this 15th day of January, 1947.

Samuel Kaufman,
SAMUEL KAUFMAN,
Attorney for Respondents.

Dated this 31st day of January, 1947.

[Endorsement on cover:] File Nos. 51,538, 51,539. U. S. Circuit Court of Appeals; Third Circuit. Term No. 674. Commissioner of Internal Revenue, Petitioner, vs. Sidney S. Munter. Term No. 675. Commissioner of Internal Revenue, Petitioner, vs. Carl Munter. Petition for writs of certiorari and exhibit thereto. Filed November 6, 1946. Term Nos. 674 O. T. 1946, 675 O. T. 1946.

U. S. GOVERNMENT PRINTING OFFICE 1947

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Nos. 674 and 675

In the Supreme Court of the United States

OCTOBER TERM, 1946

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 674

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

No. 675

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the Circuit Court of Appeals for the Third Circuit entered in the above-entitled causes on August 7, 1946.

OPINIONS BELOW

The opinion of the Tax Court (R. 24) is reported in 5 T. C. 108, and the opinion of the circuit court of appeals (R. 40) is reported in 157 F. 2d 132.

JURISDICTION

The judgments of the circuit court of appeals were entered on August 7, 1946 (R. 45–46). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the so-called *Sansome* doctrine, under which a corporate distribution is deemed a dividend when it is made from earnings and profits of predecessor companies whose assets were acquired by the successor corporation in a tax-free reorganization, applies to a situation in which new stockholders acquire, for cash, a stock interest in the successor corporation.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix, *infra*, pp. 10–19.

STATEMENT

The facts in this case were stipulated (R. 5–23) and were so found by the Tax Court (R. 25).

Their statement by the Tax Court (R. 25–27), may be summarized as follows:

On March 21, 1940, each of the taxpayers purchased, at a price of $8 per share, 10,000 shares of common stock of Crandall-McKenzie & Henderson, Inc. (hereinafter referred to as "Crandall-McKenzie"), a Pennsylvania corporation. These shares were part of a total of 38,922 shares of stock of Crandall-McKenzie issued and outstanding. There were also 11,078 shares of unissued treasury stock (R. 25).

On June 19, 1940, Crandall-McKenzie distributed to its shareholders cash in the amount of $35,166.25, at the rate of $1.25 per share. Each taxpayer received $12,500 on the 10,000 shares held by him (R. 25–26).

Crandall-McKenzie had no earnings or profits of its own accumulated from December 4, 1928, the date of its organization, to December 31, 1939, and it had no earnings or profits in the calendar year 1940 (R. 26).

Crandall-McKenzie was formed in December 1928, pursuant to an agreement between investment bankers, two predecessor corporations, Crandall-McKenzie Company (hereinafter referred to as "Crandall") and L. Henderson & Sons, Inc. (hereinafter refered to as "Henderson, Inc."), and shareholders of these corporations, O. McKenzie and L. Henderson, respectively. It acquired all the assets of the two predecessor

corporations in exchange for 24,131 shares of its stock and $355,247.75 in cash.[1] The Crandall-McKenzie stock and the cash were received by the stockholders of the two predecessor corporations in exchange for their stock therein. The remaining 25,869 shares of Crandall-McKenzie stock were issued to new interests for cash in the amount of $486,893.92 (R. 26).

All the assets of Henderson, Inc., were acquired by Crandall-McKenzie solely in exchange for 9,524 shares of its stock. At the time of acquisition, Henderson, Inc. had earnings and profits accumulated subsequent to March 1, 1913, of $74,743.62 (R. 26).

The assets of Crandall were acquired by Crandall-McKenzie for 14,607 shares of its stock and $355,247.75 in cash. At the time of acquisition, Crandall had earnings and profits accumulated subsequent to March 1, 1913, of $329,267.95 (R. 26).

From December 4, 1928, the date of its organization, to December 31, 1939, Crandall-McKenzie had aggregate earnings and profits of $401,470.07. During the same period it made aggregate cash distributions of $369,452.30 to shareholders and liquidated or purchased 11,078 shares of its own $1 stated value stock for $72,211.13 in cash. In

[1] These exchanges have been held to fall within the nonrecognition provisions of Section 112 (b) (3) and 112 (c) (1) of the Revenue Act of 1928. Appendix, *infra*, p. 11 (R. 28).

1940, it had a net loss of $37,252.47 and liquidated or purchased 12,805 shares of its stock for $94,441.90 in cash (R. 27).

The Commissioner treated the cash distribution of $12,500 each received by the taxpayers in 1940 from Crandall-McKenzie as a distribution of earnings or profits accumulated subsequent to March 1, 1913, and therefore taxable as a dividend (R. 27). The Tax Court affirmed this determination (R. 25–35), one judge dissenting (R. 35–38). The circuit court of appeals reversed the Tax Court, with one judge dissenting (R. 40–45).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the cash distribution made by Crandall-McKenzie to its stockholders was not a dividend within the meaning of Section 115 (a) of the Internal Revenue Code.

2. In holding that, after a reorganization under Section 112 (i) (1) (A) of the Revenue Act of 1928, the earnings or profits of the two predecessor corporations did not become the earnings or profits of the distributing corporation.

3. In reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

In *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2), certiorari denied, 287 U. S. 667, the Circuit Court of Appeals for the Second Circuit (per L. Hand, C. J.) held that when there is a corporate reorganization which results in no gain or loss under the non-recognition provisions

of the federal income tax laws (see *e. g.*, Section 112 of the Revenue Act of 1928, Appendix, *infra*, pp. 11–13), the earnings or profits of the predecessor company remain, for purposes of distribution, earnings or profits of the successor. This decision has been followed in later decisions of the circuit courts of appeals,[2] and, in *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, this Court indicated its approval of the doctrine there announced.

Congress has, moreover, adopted the principle of the *Sansome* case and has enacted it as part of the revenue law. See Section 115 (h) of the Internal Revenue Code (Appendix, *infra*, pp. 15–16), and Sections 115l and 718 (b) (3) of the Internal Revenue Code as added by Sections 501 and 201, respectively, of the Second Revenue Act of 1940, 54 Stat. 974, 26 U. S. C. 115, 718. Indeed, Congressional committees have made specific reference to the *Sansome* decision in their reports.[3]

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[2] See, e. g., *United States* v. *Kauffmann*, 62 F. 2d 1045 (C. C. A. 9); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5); *Fain* v. *Commissioner*, 76 F. 2d 1008 (C. C. A. 5), certiorari denied, 296 U. S. 588; *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2); *Corrigan* v. *Commissioner*, 102 F. 2d 1010 (C. C. A. 3), certiorari denied, 308 U. S. 576; *Gearday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4).

[3] Congress first incorporated the principle completely in Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and has indicated its approval of the rule in connection with that and other revenue acts. S. Rep. No. 2156, 74th

In refusing to apply the *Sansome* doctrine in this case, the court below has read into it an exception for which there is no justification in the authorities. Its reliance on the fact that new stockholders bought into the successor corporation (R. 42) is misplaced. The *Sansome* doctrine rests on the proposition that a transaction which was not recognized as a sale or other disposition of corporate assets for the purpose of attributing gain or loss to the corporation conveying the assets is not to be recognized as a transaction converting accumulated profits into capital. The taxability of the distribution depends upon the source from which it came; the introduction of new capital is wholly irrelevant to this question.

The reliance of the court below on the absence of identical proprietary interests in the old corporation and the new (R. 42) is in conflict with the decision of the Circuit Court of Appeals for the First Circuit in *Putnam* v. *United States*, 149 F. 2d 721. In that case, the *Sansome* doctrine was applied although the old stockholders there "did not retain the same interest in the assets trans-

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Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690), relating to Section 115 (h) of the Revenue Act of 1936; S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792), relating to Section 115 (h) of the Revenue Act of 1938; H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41, 42 (1940–2 Cum. Bull. 496, 526, 527); and S. Rep. No. 2114, Part 1, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 528, 545, 548), relating to Section 501 of the Second Revenue Act of 1940.

ferred which they had before". See 149 F. 2d at 727. It is true that, in the *Putnam* case, the court said that the old stockholders "received a compensatory interest in the assets of" the new corporation "which they did not have before", and that, in that manner, "their proportionate proprietary interest was maintained": *Ibid.* But that can only mean that the stockholders of a predecessor corporation continued to have, *inter sese*, the same proportionate interests. Even if that be a relevant factor, it is equally true here. See also *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6).

The importance of the issue is manifest. There have been many non-taxable corporate reorganizations during the past few decades, and the principle has become firmly established that the earnings and profits of the predecessor corporations retain their status as earnings and profits for tax purposes in the hands of the successor corporations. Undoubtedly, many such reorganizations have been accompanied by the introduction of some new capital, and it is a matter of considerable importance that the tax status of the earnings and profits accounts of such corporations be settled, particularly in view of the foregoing conflict.[4]

[4] In reaching the result herein, the court below relied upon its prior decision in *Campbell* v. *United States*, 144 F. 2d 175, which involved not only the foregoing issue, but also the question whether the earnings and profits account had

CONCLUSION

For the foregoing reasons, this petition for writs of certiorari should be granted.

Respectfully submitted,

GEORGE T. WASHINGTON,
Acting Solicitor General.

NOVEMBER, 1946.

---

been exhausted by a prior distribution of cash in connection with the reorganization. Although the taxpayers attempted to raise a similar question in this case, the Tax Court, upon the basis of this record, ruled against them (R. 34–35), and the court below expressly refrained from considering the point (R. 42, note 5).

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(b) *Adjustment of basis.*—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item, properly chargeable to capital account, and

* * * * * *

(3) In the case of stock the basis shall be diminished by the amount of distributions previously made in respect of such stock, to the extent provided under the law applicable to the year in which the distribution was made.

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * * *

(b) *Exchanges solely in kind.*—

* * * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * * *

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee

such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(d) *Same—gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of money and the fair market value of such other property so received, which is not so distributed.

* * * * *

(h) *Same—effect on future distributions.*—The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of section 115(b) for the pur-

pose of determining the taxability of subsequent distributions by the corporation.

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS

* * * * *

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital ac-

count shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(h) *Definition of partial liquidation.*— As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) [as amended by Public Salary Tax Act of 1939, c. 59, 53 Stat. 574, Sec. 1] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall

not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115. (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(26 U. S. C. 115.)

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 578. *Source of distribution of stock or securities.*—The general rule, provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to a distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or of stock or securities in a corporation a party to the reorganization. Such a distribution will not be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, which are available for distribution and which under section 115 (b) must be distributed before earnings

and profits accumulated before March 1, 1913, may be distributed exempt from tax.

Example: The X Corporation has a capital of $100,000, earnings and profits accumulated prior to March 1, 1913, of $25,000, and earnings and profits of $50,000 accumulated after February 28, 1913. It causes the organization of the Y Corporation, to which it transfers $50,000 of its assets in exchange for all of the stock of the Y Corporation. It then distributes the stock of the Y Corporation as a dividend to its shareholders. No gain to the shareholders from the receipt of this stock will be recognized under the provisions of section 112 (g) and article 576, nor will the distribution be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, on hand for a subsequent distribution as a dividend.

The provisions of this article apply to the case in which the X Corporation distributes the stock of the Y Corporation as a dividend, the case in which the X Corporation distributes the stock of the Y Corporation in retirement of a portion of the stock of the X Corporation, and the case in which the Y Corporation issues its stock direct to the shareholders of the X Corporation.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.115–2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most

recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first*, to the earnings or profits of the taxable year; *second*, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third*, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth*, to sources other than earnings or profits only after the earnings or profits have been distributed.

* * * The portion of each such distribution which is not regarded as out of earning or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. * * *

* * * * * *

SEC. 19.115–9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend.

* * *

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U. S. GOVERNMENT PRINTING OFFICE: 1946

Nos. 674 and 675

In the Supreme Court of the United States

OCTOBER TERM, 1946

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

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CARL MUNTER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 20–29) is reported in 5 T. C. 108, and the opinion of the Circuit Court of Appeals (R. 41–46) is reported in 157 F. 2d 132.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on August 7, 1946 (R. 46–47). The

petition for writs of certiorari was filed on November 6, 1946 (R. 50), and was granted on December 16, 1946 (R. 49). The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the *Sansome* rule, under which a corporate distribution is deemed a dividend when it is made from earnings and profits of predecessor companies whose assets were acquired by the successor corporation in a tax-free reorganization, applies to a situation in which new stockholders, upon the reorganization, acquire, for cash, a stock interest in the successor corporation, with consequent change in the proportionate interest of the old stockholders in the enterprise.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix, *infra*, pp. 34–44.

STATEMENT

The facts in these cases, consolidated for hearing in the Tax Court (R. 20), were submitted upon a stipulation of facts (R. 8–19) which the Tax Court incorporated by reference as its findings of fact (R. 21) and summarized in its opinion (R. 21–29).

On March 21, 1940, each of the taxpayers purchased, at a price of $8 per share, 10,000 shares

of common stock of Crandall-McKenzie & Henderson, Inc. (usually referred to below as the "New Corporation"), a Pennsylvania corporation (R. 8–9). These shares were part of 38,922 shares of stock of the New Corporation issued and outstanding; there were in addition 11,078 shares of treasury stock (R. 9), thus totaling 50,000 shares. These 50,000 shares were all common stock and of the stated value of $1 per share and were all the capital shares that the New Corporation had issued from the date of its organization (R. 14).

On June 19, 1940, the New Corporation distributed to its common shareholders $35,166.25 in cash at the rate of $1.25 per share. Each taxpayer received $12,500 on the 10,000 shares held by him. (R. 9.)

The New Corporation had been organized on December 4, 1928 (R. 14), pursuant to an agreement with investment bankers (K. W. Todd & Company). (R. 21.) In exchange for 24,131 shares of its stock and $355,247.75 in cash, the New Corporation had acquired all the assets of two predecessor corporations, Crandall-McKenzie Company (usually referred to below as "Crandall"), and L. Henderson & Sons, Inc. (usually referred to below as "Henderson, Inc."). (R. 21.) All the assets of Henderson, Inc., one of the predecessor corporations, were acquired by the New Corporation solely in exchange for 9,524 shares of New Corporation stock (R. 21). While the acqui-

sition of the Crandall assets was accomplished by means of a complex series of transactions,[1] the

[1] The particulars of these transactions are as follows: O. McKenzie owned 842½ of the Crandall shares and A. E. Crandall owned the same number. (R. 21.) The agreement with the investment bankers on the one hand, and O. McKenzie as stockholder in Crandall, and L. Henderson as stockholder in the other predecessor corporation (Henderson, Inc.), on the other, provided that the latter would cause A. E. Crandall to sell to the New Corporation his 842½ shares for $300,000 (R. 21–22). However, Crandall opposed the consolidation and would neither sell his stock to the New Corporation nor exchange his stock for stock of the New Corporation, but he did sell his stock to O. McKenzie for $300,000 (R. 22). The New Corporation then purchased from O. McKenzie 1,685 shares of Crandall stock as a block (being the stock formerly owned by A. E. Crandall, together with the 842½ shares which O. McKenzie owned originally) for $300,000, and 12,181 shares of New Corporation stock (R. 22). By a modification of the plan of reorganization as originally adopted, Kapp and Brown, two other stockholders of Crandall, each owning 100 shares of its stock, exchanged their Crandall holdings for 1,213 shares of New Corporation stock, plus $15 in cash (R. 13), and each of them became an officer or employee of the new company. The New Corporation purchased 25 additional shares of Crandall (originally belonging to Ayers and Hasson) at $315.53 a share, for $7,888.25 (R. 11–12). Finally the New Corporation purchased the remaining 150 shares of Crandall stock, belonging to 104 stockholders, for $47,329.50 (R. 12–13).

In acquiring the assets of Henderson, Inc., the New Corporation issued 9,524 shares of its stock to L. Henderson and associates, stockholders of this predecessor corporation, in exchange for the 700 outstanding shares of Henderson, Inc. (R. 13–14).

The New Corporation, by means of the stock of each of the predecessor companies thus acquired, caused dissolution of the predecessor companies, and the assets of each, subject to liabilities, were transferred to the New Corporation (R. 12–13).

Tax Court found that, in substance, the assets of Crandall were acquired by the New Corporation for 14,607 shares of its capital stock and $355,247.75 in cash (R. 21). The acquisitions and distributions were as follows:

Crandall shares	From Crandall stockholders	For consideration of—	
		New Corporation shares	Cash
1,685	O. McKenzie	12,181	$300,000.00
240	Kapp and Brown	2,426	30.90
25	Ayers and Masson		7,888.25
150	104 stockholders		47,329.50
2,000		14,607	355,247.75

Thus 24,131 shares of the New Corporation and the cash were received by stockholders of the two predecessor corporations for their stock in the predecessor companies.

The remaining 25,869 shares of the total 50,000 shares were issued by the New Corporation to new interests for cash in the amount of approximately $489,893.92 (R. 21).

At the time of the acquisition of its assets by the New Corporation, Crandall had earnings and profits accumulated subsequent to March 1, 1913, of $329,267.95, and L. Henderson & Sons, Inc., had similar earnings and profits of $74,743.62, making a total of $404,011.57 earnings and profits (R. 21). It was stipulated (R. 9) that the New Corporation "had no earnings and profits accumulated from December 4, 1928 to December 31, 1939,

and it had no earnings or profits in its taxable year January 1, 1940 to December 31, 1940."

It was further stipulated (R. 14) that from December 4, 1928, the date of its organization, to December 31, 1939, the New Corporation "had aggregate earnings and profits of $401,470.07, made aggregate cash distributions to shareholders of $369,452.30, and acquired by purchase for cash 11,078 shares $1.00 par value of its own stock for $72,211.13", and that in 1940, it had a net loss of $37,252.47 and acquired by purchase for cash 12,805 shares of its own stock for $94,441.90.[2]

The Commissioner treated the cash distribution of $12,500 received by each of the taxpayers in 1940 from the New Corporation as a distribution of earnings or profits accumulated subsequent to March 1, 1913, and therefore taxable as an ordinary dividend (R. 22).

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[2] The stipulations described in this paragraph and in that immediately preceding may be inconsistent. Since there were earnings and profits of $401,470.07 and distributions of only $369,452.30, there may have been earnings of $32,017.77 which had not been distributed as of January 1, 1940. The New Corporation's purchase of 11,078 shares of its own stock for $72,211.13 in cash may not have affected these earnings. Neither the stipulation nor the Tax Court's findings indicate that these shares were cancelled or redeemed. The record does show that the New Corporation issued 50,000 shares upon its organization, no new shares were ever issued, and, on March 21, 1940, there were 11,078 shares of treasury stock outstanding (R. 8-9, 14). The Tax Court did not decide whether or not the purchase of these shares affected earnings or profits (R. 22, n. 1, R. 42, n. 3). This is an issue which the Tax Court should decide, if the case is remanded as suggested by the dissenting judge in the court below (R. 46).

The Tax Court sustained this determination (R. 20–27), one judge dissenting (R. 27–29). Holding that the New Corporation took the accumulated earnings and profits of the predecessor corporations as its earnings and profits, and that the identity of the interests of the stockholders of the predecessor corporation in the succeeding company was not the basis for the *Sansome* doctrine, it declined to follow the contrary holding of the court below in the first branch of its decision in *Campbell* v. *United States*, 144 F. 2d 177 (R. 25), and further concluded that the second ground of decision in the *Campbell* case was inapplicable to the instant record, since no cash distributions were made to Henderson stockholders and there was here no basis of fact to support a finding that Crandall's earnings and profits had been exhausted when distributions of cash were made to its stockholders (R. 26–27).

The court below, relying on the first ground of its prior decision in the *Campbell* case, reversed the Tax Court, Judge O'Connell dissenting (R. 44–46), (R. 41–44); the Court found it unnecessary to determine the applicability of the second ground of the *Campbell* decision (R. 42, n. 3, R. 43, n. 5).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the cash distribution made by the New Corporation to its stockholders was

not a dividend within the meaning of Section 115 (a) of the Internal Revenue Code.

2. In holding that, after a reorganization under Section 112 (i) (1) (A) of the Revenue Act of 1928, the earnings or profits of the two predecessor corporations did not become the earnings or profits of the distributing corporation.

3. In reversing the decision of the Tax Court.

SUMMARY OF ARGUMENT

A. In concluding that the earnings and profits of the old companies were transferred to the New Corporation as earnings and profits for tax purposes (and not, as the majority of the court below held, as capital), the Tax Court expressly relied upon the so-called *Sansomé* rule. This doctrine, as originally developed in *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, and as repeatedly recognized in subsequent cases, is a rule of statutory construction, that an exemption from taxation incident to a transfer in a tax-free reorganization implies a Congressional purpose that the earnings and profits of transferor companies should remain earnings and profits in the hands of acquiring companies for purposes of distribution to stockholders; its basis is to prevent tax avoidance by the device of a tax-free reorganization.

B. The *Sansome* rule is not only a well-settled judicial doctrine, repeatedly approved and ap-

plied by the courts, but it is, moreover, confirmed by statute and long standing Treasury Regulations, having the force of law. Congressional Committee Reports have repeatedly cited or stated the *Sansome* principle with approval as existing law. Section 115 (h) of the Internal Revenue Code and Section 19.115–11 of Treasury Regulations 103, having the force of law, here controlling and applicable, sanction the rule.

C. The only obstacle which the court below found to the application of the *Sansome* rule was the circumstance that, as an incident to the reorganization, new stockholders acquired, for cash, an interest in the New Corporation with a consequent change in the proportionate interest of the old stockholders in the enterprise. The court below erred in narrowly circumscribing the *Sansome* doctrine to cases where an identity of proprietary interest is maintained throughout the reorganization. The purpose of the *Sansome* rule is to prevent tax avoidance; the undistributed earnings of the predecessor corporations do not disappear and unless taken over, as such, by the new company, they escape proper taxation. These earnings are transferred tax-free as much, in the case where the identity of proprietary interest in the successor corporation differs from that of the predecessors, as where the identity of the proprietary interest remains unchanged; there is no more reason for them to escape taxation when

distributed by the transferee in one case than in the other, and the necessity of closing the door to this form of tax avoidance is equally present whether or not new capital has come into the enterprise. As in the *Sansome* case, the instant transaction is one which by mandate of statute is deemed not to break the continuity of corporate life despite the introduction of new capital. Certainly, once the statutory definition of continuity of corporate life provided by the reorganization provisions is abandoned as a basis for application of the *Sansome* rule, and a rigid standard of identity of proprietary interest substituted, the *Sansome* rule becomes so narrow as to be valueless for prevention of tax evasion since it would apply to relatively few reorganizations. On the other hand, if a test of substantial identity be substituted, the test becomes so vague as to be impracticable of administration. If the decision below is correct, it will be as difficult to draw the line between identity and non-identity as between those changes of form and substance which were the subject of controversy before there were reorganization statutes.

The distinction taken by the court below is not only in disagreement with other judicial authority, but it directly conflicts with the applicable statute and Regulations. These apply to all reorganizations in which gain is not recognized, not merely those in which identity of proprietary in-

terest is preserved; they do not recognize the limitation imposed upon the *Sansome* rule by the court below.

ARGUMENT

THE *SANSOME* RULE APPLIES TO A SITUATION IN WHICH, UPON THE REORGANIZATION, NEW STOCKHOLDERS ACQUIRE FOR CASH A STOCK INTEREST IN THE SUCCESSOR CORPORATION WITH CONSEQUENT CHANGES IN THE PROPORTIONATE INTEREST OF THE OLD STOCKHOLDERS IN THE ENTERPRISE

A. *The basis of the* Sansome *rule is the prevention of tax avoidance through the device of a tax-free reorganization.*—In concluding that the earnings and profits of the old companies, aggregating $404,011.57, were transferred to the New Corporation as its earnings and profits for tax purposes (and not, as the majority of the court below held, as capital), the Tax Court expressly relied upon the rule, first enunciated by Judge Learned Hand in *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667. There a newly organized corporation acquired in a tax-free reorganization the entire assets of another corporation subject to its liabilities; in return the new corporation transferred all of its stock to the stockholders of the predecessor in the same proportional interests as their stockholdings in the old company. The old company was then dissolved and the new company, after operating without net earnings, subsequently discontinued business and made distribution to its stockholders in liquidation. Under the Revenue Act of 1921,

controlling the *Sansome* case, a liquidating dividend was taxable as an ordinary dividend to the extent of the corporation's earnings. *Commissioner* v. *Sansome, supra,* p. 923. The Second Circuit Court of Appeals held that the earnings and profits of the predecessor company had been carried over, as such, into the new company as its earnings and profits, and, that, to the extent of these transferred earnings, the liquidation distribution by the new company was taxable to the stockholders of the new company as a dividend. This conclusion was reached even though the Revenue Act of 1921 did not contain any provision expressly dealing with this problem.[3]

[3] Section 203 (g) of the Revenue Act of 1924, c. 234, 43 Stat. 253, provides:

"The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of subdivision (b) of section 201 for the purpose of determining the taxability of subsequent distributions by the corporation."

The provision was continued in effect in Section 203 (g) of the Revenue Act of 1926, c. 27, 44 Stat. 9, and Section 112 (h) of the Revenue Act of 1928, c. 852, 45 Stat. 791. In Section 112 (h) of the Revenue Act of 1932, c. 209, 47 Stat. 169, the phrase "if no gain to the distributee from the receipt of such stock or securities was recognized by law" was inserted before the phrase "shall not be considered". This amendment was prompted by the addition of Section 112 (k) under which certain exchanges, involving foreign corporations, would not be tax-free under Section 112 (h). See H. Rep. 708, 72nd Cong., 1st Sess.,

In his dissenting opinion in *Campbell* v. *United States*, 144 F. 2d 177 (C. C. A. 3d), Judge Jones aptly states the rationale of the *Sansome* doctine (p. 183):

> In so deciding, Judge Learned Hand, who spoke for the Court, said (60 F. 2d at page 933) that "what was not 'recognized' as a sale or disposition for the purpose of fixing gain or loss [i. e., the reorganization exchange], should [not] be 'recognized' as changing accumulated profits into capital * * *." As it was the intent of Congress, as evidenced by the Revenue Acts, to tax as dividends corporate distributions of earnings accumulated since February 28, 1913, manifestly, to accord such distributions freedom from taxation, when ultimately received by stockholders, merely because of coincidental bookkeeping attendant upon a successor corporation's acquisition of a predecessor's business and assets as the result of a reorganization, would be violative of the congressional intent. It necessarily foi-

p. 20 (1939-1 Cum. Bull. (Part 2) 457, 471). In the Revenue Act of 1934, c. 277, 48 Stat. 680, the provision was transferred from the exchange section to the dividend section and became Section 115 (h). It will be noted that under all of these statutes, the ineffectiveness of such a distribution to diminish earnings and profits was clearly prescribed only as to the distributing corporation. Section 115 (h) of the Revenue Acts of 1936 and 1938, discussed hereinafter, made it clear that the same rule applied as to subsequent distributions by any corporation involved in the reorganization.

> lowed, therefore, as a corollary, that the non-recognition of gain or loss allowed by the reorganization provision there involved (*See*. 202 (c) (2) of the Revenue Act of 1921) should, i.. the words of Judge Hand, "be read as a gloss upon section 201" (the taxable dividend definition of the Revenue Act of 1921). Accordingly, it was held in the *Sansome* case, 60 F. 2d at page 923), *as a matter of statutory construction*, "that a corporate reorganization which results in no 'gain or loss' under section 202 (c) (2) (42 Stat. 230) does not foll the company's life as continued venture ir der section 201, and that what were 'earni igs or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation."

Section 112 (b) (3) and (i) (1) (A) of the controlling Revenue Act of 1928 and Sections 115 (a) and (b) of the Internal Revenue Code (Appendix, *infra*, pp. 35, 37, 38–39), here involved, are substantially the same as Sections 202 (c) (2) and 201 (a) and (b) of the Revenue Act of 1921 dealt with in the *Sansome* case.

In *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892, this Court, citing with apparent approval the *Sansome* case, by analogous reasoning came to a similar conclusion with respect to the tax effect of tax-free transactions upon corporate gains and losses as reflected in corporate earnings and profits, saying:

> Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§ 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. Compare *Commissioner* v. *Sansome*, 60 F. 2d 931, and see Sen. Rep. No. 2156, 74th Cong., 2d Sess., p. 19; H. R. Rep. No. 2894, 76th Cong., 3d Sess., p. 41.

The circumstance that as a matter of bookkeeping practice, the predecessor's assets may be recorded as capital and not as earnings or profits in the successor's books is immaterial, for, as this Court further stated with respect to the analogous situation involved in the *Wheeler* case (p. 546):

> The taxpayers are insisting on using as a base for tax purposes a figure that in itself has no relation to taxation. It was no doubt permissible and perhaps the correct accounting, for determining earned surplus for dividends and such corporate purposes, for the corporation to set up its books on the market value of its property at the time of acquisition, which determined the value of the stock it issued. But "earnings and profits" in the tax sense, although it does not correspond exactly to taxable income,

> does not necessarily follow corporate accounting concepts either.

Indeed, so the First Circuit Court of Appeals has held in a factual situation requiring application of the *Sansome* rule. *Putnam* v. *United States*, 149 F. 2d 721, 726.

Thus, the *Sansome* doctrine, as originally developed, is a rule drawn from the relevant statutes to the effect that the exemption from taxation incident to a transfer in a tax-free reorganization implies a Congressional purpose to have the earnings and profits of the transferor companies remain earnings and profits in the hands of acquiring companies for the purpose of distributions to stockholders. The basis of the rule is the prevention of tax avoidance by the device of a tax-free reorganization. This was recognized by the Fifth Circuit Court of Appeals in one of the earliest of the many cases that have applied the *Sansome principle*, when it said in *Marchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642, that:

> Unless the undistributed gains of the old business are taken over by the new as undivided profits distributable as dividends, they escape proper taxation

and it finds renewed expression in one of the most recent, where the First Circuit Court of Appeals said, in *Putnam* v. *United States*, *supra*, p. 726: "The purpose of the *Sansome* rule is to prevent tax evasion". This is also the reasoning

of Judge O'Connell, in his dissenting opinion in the court below (R. 45).[4]

The *Sansome* rule, shortly after its enunciation, was applied, in *United States* v. *Kauffmann*, 62 F. 2d 1045 (C. C. A. 9th), to ordinary (non-liquidating) dividends, such as the Commissioner seeks to tax in the instant case. In *Corrigan* v. *Commissioner*, 103 F. 2d 1010, certiorari denied, 308 U. S. 576, likewise involving the taxation of an ordinary dividend, distributed subsequent to a reorganization, the court below approved the *Sansome* rule by expressing its agreement with and following Second Circuit decisions in *Baker* v. *Commissioner*, 80 F. 2d 813, and *Cable* v. *Commissioner*, 102 F. 2d 977, certiorari denied, 308 U. S. 575, which had applied it. The *Sansome* principle has been repeatedly affirmed and approved in many decisions in addition to those already cited. *Fain* v. *Commissioner*, 76 F. 2d 1008 (C. C. A. 5th), certiorari denied, 296 U. S. 588; *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d); *Geerday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4th); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Robinette* v. *Commissioner*, 148 F. 2d 513 (C. C. A. 9th); *Barnes* v. *United States*, 22 F. Supp. 282 (E. D.

[4] The Sixth Circuit Court of Appeals has recently held the *Sansome* rule applicable under the Revenue Act of 1918. *National Sanitary Co.* v. *Commissioner*, decided February 10, 1947 (1947 C. C. H., ¶ 9163).

Pa.); *Riverside Cement Co.* v. *Rogan*, 59 F. Supp. 401 (S. D. Cal.); *Crocker* v. *Commissioner*, 29 B. T. A. 773; *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188; *Mandel* v. *Commissioner*, 5 T. C. 684.

B. *The correctness of the statutory construction embodied in the* Sansome *rule has been confirmed by Congress in successive Revenue Acts and by Treasury Regulations having the force of law.*—The *Sansome* rule is not only a well settled judicial doctrine, authorized by many court decisions over an extended period, but it is, moreover, confirmed by statute and long standing Treasury Regulations, having the force of law. The *Sansome* case was decided in 1932; the *Kauffman* case in 1933; and *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5th), in 1935. In framing the 1936 Revenue Act, the Senate Committee on Finance proposed Section 115 (h), quoted in the footnote,[5] in the form in

[5] Revenue Act of 1936, c. 690, 49 Stat. 1648:

"SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * *

"(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

"(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

"(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income

which it was eventually enacted. This proposal was not understood to change "existing law" (see note 3, *supra*, pp. 12–13), but was deemed desirable "in the interest of greater clarity", and it was specifically made applicable to distributions made before January 1, 1936. In recommending the amendment, the Finance Committee said (S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690)):

> SECTION 115 (H). EFFECT OF DISTRIBUTIONS ON EARNINGS AND PROFITS
>
> The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a nontaxable stock dividend or a distribution of stock or securities in connection with a reorganization or other exchange, *on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.* This rule is stated only

to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

"As used in this subsection the term 'stock or securities' includes rights to acquire stock or securities."

> in part in section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner* v. *Sansome*, 60 Fed. (2) 931; *U. S.* v. *Kauffman*, 62 Fed. (2) 1045; *Murcheson* v. *Comm.*, 76 Fed. (2) 641. While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity. [Italics supplied.]

The italicized language of this Committee Report, which states the *Sansome* rule (as, indeed, the Committee explicitly notes), was carried over substantially verbatim into Treasury Regulations 94, promulgated under the Revenue Act of 1936, Art. 115–11, implementing the amended Section 115 (h) and other provisions of the 1936 Act. Thus, this article of the Regulations[6] makes clear that the *Sansome* rule is applicable in the case of reorganizations in which gain is not recognized in full, and makes explicit what is necessarily implied by Section 115 (h) of the statute, that non-taxable distributions which Section 115 (h) states are not "considered a distribution of

[6] This article is not quoted for the reason that, except for additions that have no materiality here (see footnote 7, *infra*, pp. 21–22), it is identical with Section 19.115–11 of Regulations 103 under the Internal Revenue Code, Appendix, *infra*, pp. 42–44.

earnings or profits of any corporation" do not, in the words of the Regulations, "diminish the earnings or profits of any corporation" and that they "remain intact and available for distribution" by the "corporation to which the earnings or profits are transferred upon such reorganization or other exchange". The Regulations further specify that this rule is applicable to such distributions made in any earlier year.

In Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, the words "property or money" were added after the phrase "stock or securities" and these amendments also were made applicable to distributions made before the passage of that Act. Save for the change made necessary by this amendment, Article 115–11 of Treasury Regulations 94 has been continued without substantial change under subsequent Revenue Acts and the Internal Revenue Code controlling in the tax year here involved.[7] Section 115 (h)

[7] Treasury Regulations 101, under the Revenue Act of 1938, Art. 115–11; Treasury Regulations 103, under the Internal Revenue Code, Sec. 19.115–11, here applicable (Appendix, *infra*, pp. 42–44); and Treasury Regulations 111, under the Internal Revenue Code, Sec. 29.115–11, applicable to years beginning after December 31, 1941. Treasury Regulations 103, Sec. 19.115–11 and Treasury Regulations 111, Sec. 29.115–11, were amended, respectively, by T. D. 5299, 1943–1 Cum. Bull. 747, and T. D. 5304, 1943–1 Cum. Bull. 367, subsequent to the tax year here involved, which inserted imme-

of the Internal Revenue Code (Appendix, *infra*, p. 39), the statute here applicable, is substantially the same as Section 115 (h) of the Revenue Act of 1938.[8] On familiar principles, Treasury Regulations, long continued without substantial change, and applying to an unamended or substantially re-enacted statute, are deemed to have received Congressional approval and have the force of law. *Taft* v. *Commissioner*, 304 U. S. 351, 357; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Douglas* v. *Commissioner*, 322 U. S. 275, 281–282; *Bochm* v. *Commissioner*, 326 U. S. 287, 291–292.

Other reports of Congressional committees likewise recognize the *Sansome* rule as law. Thus, in recommending the amendment to the Internal Revenue Code which later, as Section 501 of the Second Revenue Act of 1940, added Section 115 (l) to the Code, and which defined the effect on corporate earnings and profits of gain or loss and of receipt of tax-free distributions, the House

diately after the [illegible] paragraph a new paragraph having no materiality here. See Treasury Regulations 103, Sec. 19.115–11 as amended, Appendix, *infra*, pp. 42–43. Treasury Regulations 111, Sec. 29.115–11 was further amended by T. D. 5402, 1944 Cum. Bull. 229, but the amendment is of no significance here.

[8] In proposing the 1938 amendment to the corresponding Section 115 (h) of the Revenue Act of 1938, the Senate Finance Committee again stated the *Sansome* rule as existing law. S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792).

Committee said (H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526)):

> Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome*, 60 F. (2d) 931, and following decisions, the rule effectuates the provisions of section 112.

The Senate Report quoted in the footnote,[9] without specifically naming the *Sansome* case, clearly restates the rule. "In recommending the provisions for computation of the excess-profits tax also contained in the Second Revenue Act of 1940, adding Section 718 (b) (3) to the Internal Revenue Code, these Committee Reports again accepted as established law the *Sansome* rule."[10]

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[9] S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 528, 546–547):

"Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. These principles are to be given full effect under section 501. The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee."

This, the court below recognized, in *Crossett Western Co.* v. *Commissioner*, 155 F. 2d 433, certiorari denied, October 14, 1946.

This Court and others have acknowledged the statutory sanction for the *Sansome* rule. *Commissioner* v. *Wheeler*, 324 U. S. 542, 546–547; *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288, 289 (C. C. A. 6th); *Robinette* v. *Commissioner*, 148 F. 2d 513, 516 (C. C. A. 9th); *Putnam* v. *United States*, 149 F. 2d 721, 726 (C. C. A. 1st); *Mandel* v. *Commissioner*, 5 T. C. 684, 690.

C. *The* Sansome *rule applies to this case.*—The court below agreed with the Tax Court that the transaction under which the New Corporation acquired all of the assets of the two old companies, Crandall and Henderson, Inc., constituted a reorganization under Section 112 (i) (1) (A) of the controlling Revenue Act of 1928 (Appendix, *infra*, p. 37) (R. 22–23, 43), that is—

> (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), * * *

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[10] H. Rep. No. 2894, *supra*, p. 25; S. Rep. No. 2114, *supra*, p. 14; H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940-2 Cum. Bull. 548, 555).

Under the reorganization plan, the participating stockholders of Henderson, Inc., exchanged their stock solely for stock in the New Corporation and stockholders of Crandall exchanged their stock for stock in the new company and money. As the Tax Court expressly held (R. 22–23) and the court below implied and assumed (R. 42), these exchanges were obviously tax-free to both of the predecessor corporations (see Section 112 (b) (4) and (d) of the Revenue Act of 1928; Appendix, *infra*, pp. 35, 36).[11]

[11] They were also tax-free to the stockholders of the predecessor corporations within the meaning and to the extent provided in Section 11. (b) (3) and (c) (1) of the Revenue Act of 1928. (Appendix, *infra*, p. 35.) The exchanges were necessarily tax-free as to the stockholders of Henderson, Inc., who received only stock of the new company, and the Tax Court assumed, in the absence of proof to the contrary, that the Crandall stockholders realized no gain.

Section 115 (b) of the Internal Revenue Code (Appendix, *infra*, p. 39) does not establish any specific rule where gain is recognized only to a limited degree as it is where "boot" is distributed. Under Section 112 (c) (1) and (2) of the Revenue Act of 1936 (as under the corresponding provisions of the Revenue Act of 1928), a stockholder realizing a gain from the receipt of "boot" and securities in exchange for securities in a reorganization is taxable on the gain to an amount not in excess of the "boot". Under Section 112 (c) (2) the *recognized* gain will be taxed as a dividend, if it has the effect of the distribution of a dividend. It seems obvious that the mere distribution of "boot" in a reorganization exchange does not prevent the application of the *Sansome* principle, and the Treasury Regulations recognize that the principle applies wherever the gain is not taxable in full. See

There having been a reorganization plan under Section 112 (i) (1) (A) and a substantial continuity of interest (*Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378), the situation was one which called for the application of the *Sansome* rule. However, the court below, in accordance with the first ground of its decision in the *Campbell* case, refused to apply that rule on the theory (R. 43–44) that it had no application where there was introduction of new capital with consequent changes in the proportionate interests of the old stockholders in the enterprise. It consequently held that neither the earnings of Henderson, Inc. nor the earnings of Crandall were transferred to the New Corporation. The Tax Court having declined to follow the *Campbell* case (R. 25), the court below reversed, holding "this case * * * squarely under the first exception in Campbell" (R. 43, n. 5), which "is still the law of this Circuit", and "controls the question under consideration" (R. 44). The decision below was rested solely on the lack of identity of proprietary inter-

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first paragraph of Article 115–11 of Regulations 94 and Sec. 19.115–11 of Regulations 103, *infra*, p. 42. Otherwise any cash distribution, however small, would permit the escape of large amounts of earnings and profits from tax as dividends. The excerpt from S. Rep. 2156, 74th Cong., 2d Sess., p. 19, quoted *supra*, pp. 19–20, shows that Congress thought the principle applied so long as the gain was not recognized in full. To the same effect is S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25, quoted in footnote 9, *supra*, p. 23.

ket, and the Government filed its petition for a writ of certiorari in order to secure a ruling by this Court as to whether the mere fact that new stockholders acquire for cash a stock interest in the successor corporation prevents the application of the *Sansome* rule.

In narrowly circumscribing the *Sansome* doctrine as it did, the court below erred. As pointed out in subpoint A, *supra*, pp. 11–18, and as expressed by the judges dissenting below and in the *Campbell* case, the authorities establish that the basis for the *Sansome* rule is prevention of tax avoidance by the device of a reorganization which is tax-free in whole or in part. The necessity for closing the door to this form of tax avoidance is equally present whether or not new capital has come into the enterprise. Unless the undistributed earnings and profits of the old corporations are taken over, as such, by the new, they escape proper taxation.

These "earnings do not disappear" (R. 45), and by force of the reorganization statute, they are transferred, tax-free as much in the case where the proprietary interest in the successor corporation differs from that in the predecessors as when the proprietary interest remains unchanged; there is no more reason for them to escape taxation, when distributed by the transferee, in one case than in the other. In the *Sansome* opinion, Judge Hand reasoned that Congress employed the reorganiza-

tion provisions to define certain transactions which (p. 933)—

> should not break the continuity of the corporate life, a troublesome question that the courts had beclouded by recourse to such vague alternatives as "form" and "substance," anodynes for the pains of reasoning. The effort was at least to narrow the limits of judicial inspiration. * * *.

This reasoning contradicts the essential argument of the *Campbell* opinion that an identity of proprietary interest motivated the *Sansome* decision. In this case too, the transaction is one which by mandate of statute is deemed not to break the continuity of corporate life despite the introduction of new capital, but the court below holds that the change in proprietary interests defeats the application of the *Sansome* rule. Certainly, once the statutory definition of continuity of corporate life provided by the reorganization provisions is abandoned as a basis for the application of the *Sansome* rule and a rigid standard of "identity of proprietary interest" substituted, the *Sansome* rule becomes so narrow as to be valueless for prevention of tax evasion since it would apply to relatively few reorganizations. On the other hand, if a test of substantial identity be substituted, the test becomes so vague as to be impracticable of administration. If the decision below is correct, it will be as difficult to draw the line between identity and non-identity as between those changes

of form and substance which were the subject of controversy before there were reorganization statutes. The approach suggested below, in the words of Judge Hand, must depend upon "judicial inspiration", whose limits in this connection the reorganization provisions were intended "at least to narrow."

The vital factor is not who receives earnings or profits, but that earnings or profits, which have been transferred tax-free on a reorganization, should not escape taxation upon a subsequent distribution. *Putnam* v. *United States*, 149 F. 2d 721, 722 (C. C. A. 1st). To tax the receipt of such a distribution as out of earnings and profits no more involves (*Campbell* v. *United States, supra*, pp. 180–181)—

> the contradictory concept of a corporation buying profits with money contributed by new stockholders, whereas profits by their nature must be realized from other transactions and may not themselves be acquired by purchase.

than does the undoubted right to tax a distribution to a stockholder from corporate profits, earned before he acquires his stock interest. *United States* v. *Phellis*, 257 U. S. 156, 171–172. Taxable income is not limited to increases which occur while the taxpayer owns the property. *Taft* v. *Bowers*, 278 U. S. 470, 484.[12]

[12] Nor does the cost basis fixed by statute (Section 113 (a) (7) of the Revenue Act of 1928) for assets acquired by the

As noted in subdivision B, *supra*, pp. 18–24, the rule here applicable is not founded solely on judicial interpretation; it possesses the additional sanction of statutory confirmation and of long standing Treasury Regulations, having the force of law. Neither Section 115 (h) of the Internal Revenue Code nor Section 19.115–11 of Treasury Regulations 103 confines the *Sansome* rule to the narrow limitations fixed by the court below. There is no suggestion of a limitation to cases where the identity of proprietary interests is preserved,[11] and there is no reason to doubt the validity of the Regulation. Cf. *Commissioner* v. *Wheeler*, 324 U. S. 542, rehearing denied, 325 U. S. 892.

Since the *Sansome* rule may no longer be considered solely a judicial doctrine, but is sanc-

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successor corporation affect the amount of earnings or profits acquired with the transfer of the predecessor's assets. See *Putnam* v. *United States*, 149 F. 2d 721, 726 (C. C. A. 1st).

[11] The Regulations further specify that these earnings or profits are available for distribution as dividends—

"by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange."

Where, in a tax-free reorganization, less than all of the assets of a predecessor company are transferred to the new company, the rule is that earnings and profits of the old company follow its assets proportionately in the hands of the transferee corporation. *Rogers* v. *United States*, 22 F. Supp. 282 (E. D. Pa.); *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188; *Mandel* v. *Commissioner*, 5 T. C. 684. See also, amendment to Treasury Regulations 103, Sec. 19.115–11 by T. D. 5299, 1943–1 Cum. Bull. 747, which, subsequent to tax year here involved, inserted a new paragraph immediately after the first paragraph (Appendix, *infra*, pp. 42–43).

tioned by statute and Regulations having the force of law, the over-literal argument made against it, based upon a reading of Section 115 (a) of the Internal Revenue Code (Appendix, *infra*, p. 38), that a dividend means a distribution "made by a corporation * * * out of *its* earnings or profits" (italics supplied), and that the earnings and profits here sought to be taxed are not *its*, but those of the predecessor corporations, properly held without validity in *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642 (C. C. A. 5th), seems now immaterial. Cf. *Campbell* v. *United States*, 144 F. 2d 177, 179 (C. C. A. 3rd) and dissent of Judge Jones, 144 F. 2d at 183.

Moreover, a ground of distinction between the instant case and the *Campbell* case is present here for, as appears from subpoint B, *supra*, pp. 18–24, Section 115 (h) of the Internal Revenue Code and the Regulations under it (or their predecessor cognates) were not respectively enacted or promulgated until 1936, which was subsequent to the tax years (1933 and 1934) involved in the *Campbell* case. Accordingly, while we urge that the *Campbell* decision is, in any event, incorrect as a judicial interpretation of the *Sansome* rule of construction, the decision here, as it is was not there, is additionally governed by controlling statute and regulation. We conclude, therefore, that the difference indicated in the opinion below between the facts in the *Sansome* case and in this case is without material legal significance.

The distinction taken by the court below is in disagreement with other judicial authority; it conflicts with the decision of the First Circuit Court of Appeals in *Putnam* v. *United States*, 149 F. 2d 721. In that case the *Sansome* doctrine was applied although the old stockholders there "did not retain the same interest in the assets transferred which they had before". 149 F. 2d at 727. There the acquired corporation was already in existence at the time of the reorganization but this does not alter the fact that its stockholders and capital were new stockholders and new capital insofar as the acquiring company was concerned.[14]

It is true that in the *Putnam* case, the court said that the old stockholders "received a compensatory interest in the assets of" the new corporation "which they did not have before", and that, in that manner, "their proportionate proprietary interest was maintained." *Ibid.* But that can only mean that the stockholders of a predecessor corporation continued to have, *inter sese*, the same proportionate interests. Even if that be a relevant factor, it is equally true here.[15]

[14] In citing the *Campbell* case, the *Putnam* opinion, p. 726, refers only to the dissenting opinion of Judge Jones.

[15] The lower court recognized *Croker* v. *Commissioner*, 29 B. T. A. 773, as a conflicting authority in its *Campbell* opinion, 144 F. 2d at 180, although it sought to distinguish it in its opinion below (R. 44). See also *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d).

See also *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th).

CONCLUSION

The decision of the Circuit Court of Appeals for the Third Circuit should be reversed.

Respectfully submitted.

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MARCH 1947.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(b) *Adjustment of basis.*—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item, properly chargeable to capital account, and

* * * * *

(3) In the case of stock the basis shall be diminshed by the amount of distributions previously made in respect of such stock, to the extent provided under the law applicable to the year in which the distribution was made.

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(d) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the pur-

poses of this title, shall be determined under the provisions of section 112.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges solely in kind.*—

* * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * *

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsec-

tion but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(d) *Same—gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan or reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

* * * * * *

(h) *Same—effect on future distributions.*—The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reor-

ganization, shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining the taxability of subsequent distributions by the corporation.

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

* * * * *

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) [as amended by Public Salary Tax Act of 1939, c. 59, 53 Stat. 574, Sec. 1] *General Definition.*—"Gross income" includes gains, profits, and income derived

from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently

accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(*h*) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 578. *Source of distribution of stock or securities.*—The general rule, provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to a distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or of stock or securities in a corporation a party to the reorganization. Such a distribution will not be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, which are available for distribution and which under section 115 (b) must be distributed before earnings and profits accumulated before March 1, 1913, may be distributed exempt from tax.

Example: The X Corporation has a capital of $100,000, earnings and profits accumulated prior to March 1, 1913, of $25,000, and earnings and profits of $50,000 accumulated after February 28, 1913. It causes the organization of the Y Corporation, to which it transfers $50,000 of its assets in exchange for all of the stock of the Y Corporation. It then distributes the stock of the Y Corporation as a dividend to its shareholders. No gain to the shareholders from the receipt of this stock will be recognized under the provisions of section 112 (g) and article 576, nor will the distribution be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, on hand for a subsequent distribution as a dividend.

The provisions of this article apply to

the case in which the X Corporation distributes the stock of the Y Corporation as a dividend, the case in which the X Corporation distributes the stock of the Y Corporation in retirement of a portion of the stock of the X Corporation, and the case in which the Y Corporation issues its stock direct to the shareholders of the X Corporation.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

> SEC. 19.115–2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first,* to the earnings or profits of the taxable year; *second,* to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third,* to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth,* to sources other than earnings or profits only after the earnings or profits have been distributed.
>
> * * * The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated

since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. * * *

* * * * *

SEC. 19.115–11. [as amended by T. D. 5299, 1943–1 Cum. Bull. 747] *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

If a transaction described in the preceding paragraph has occurred, there shall be included in the accumulated earnings and profits of the transferee corporation as of

the day on which such transaction occurred the proportionate part of any earnings and profits of the transferor corporation accumulated as of such day and properly allocable to the transferee; and there shall be included in the current earnings and profits of the transferee for the taxable year of the transferee in which such transaction occurred the proportionate part of the earnings and profits of the transferor accumulated after the beginning of such taxable year and properly allocable to the transferee. The amount so included in the current earnings and profits of the transferee shall not exceed such proportionate part of the earnings and profits of the transferor accumulated as of the day on which such transaction occurred.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

* * * * *

A distribution described in paragraph (1), * * * above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. * * *

For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

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Nos. 674 and 675

In the Supreme Court of the United States

OCTOBER TERM, 1946

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

I

INTRODUCTION

This reply brief is submitted pursuant to leave granted by the Court at oral argument. It is made necessary by the taxpayers' failure to attempt to support the judgments below on the ground on which those judgments were rested and

their attempt to sustain the judgments on grounds upon which the court below found it unnecessary to pass.

In *Campbell* v. *United States*, 144 F. 2d 177, the court below announced two so-called exceptions to the rule of the *Sansome* case. The first asserted exception was put in these terms (144 F. 2d at 180):

> The identity of proprietary interest which existed in the Sansome case and motivated the court to disregard the corporate entities and treat the earnings of the predecessor corporation as though they were earnings of the successor corporation is, therefore, completely lacking. We think that for this reason alone the doctrine of the Sansome case, which by judicial construction operates to transfer earnings from the corporation which earned them to its successor in reorganization, is inapplicable.

The second so-called exception was thus described (144 F. 2d at 181):

> The doctrine of the Sansome case that the accumulated earnings of the predecessor corporation in a tax-free reorganization shall be deemed carried over to the successor corporation for the purpose of distribution to its stockholders as dividends cannot apply to a situation where the accumulated earnings of the predecessor corporation have been distributed to its stockholders at the time of the reorganization. Obviously

> earnings cannot at one and the same time be distributed to the stockholders of the predecessor corporation and transferred to the successor corporation.

In the cases at bar, the court below found it unnecessary to pass upon the applicability of the second "exception" described in its *Campbell* opinion "since this case is squarely under the first exception in Campbell" (R. 43, note 5).[1] The only question presented in the petition to this Court upon which certiorari was granted and with respect to which the Government seeks a ruling is, as there stated (p. 2):

> Whether the so-called *Sansome* doctrine, under which a corporate distribution is deemed a dividend when it is made from earnings and profits of predecessor companies whose assets were acquired by the successor corporation in a tax-free reorganization, applies to a situation in which new stockholders acquire, for cash, a stock interest in the successor corporation.

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[1] It is clear that the sentence from the opinion of the court below (R. 44) quoted by taxpayers in their brief (p. 9), and which they assert "explains the grounds of its decision," was merely descriptive and not intended in any way to limit the lower court's holding that the case is squarely under the first exception in *Campbell*. Indeed, this plainly appears from the sentence in the opinion immediately following that quoted by taxpayers, reading as follows (R. 44):

> The Tax Court recognizes that the facts are directly within the first branch of the Campbell decision but contends for the general application of the Sansome principle.

It was this question, the propriety of refusing to apply the *Sansome* doctrine on the grounds described by the court below as the "first exception in Campbell" (R. 43, note 5), that was the subject of the Government's main brief in this Court. Taxpayers, however, both in their brief, and on oral argument, rested their case not on the "first exception," but, instead, principally patterned their contentions on the "second exception" in *Campbell*. See, in particular, Br. 15.

We believe that it would be inappropriate for this Court to reach the issue now posed by the taxpayers. The parties and the Court have not had the benefit of the views of the court below on this issue, and, under such circumstances, a remand would seem to be required after this Court answers the question presented by the petition for certiorari. *United States* v. *Ballard*, 322 U. S. 78, 88. The conclusion that this course would be the better one is buttressed by the fact, noted by the dissenting judge below (R. 46), that the findings of the Tax Court do not supply a wholly adequate foundation for the resolution of the issue now mooted by the taxpayers.

We propose, in this brief, to support our assertion that a remand is required by the lack of crystallization of the issues and the absence of adequate Tax Court findings. We think that our discussion will also show that these cases cannot be decided without a ruling on the question pre-

sented in the petition for certiorari, since even the record as now made indicates that there is little substance to the taxpayers' contention that the cases can be entirely disposed of on the grounds upon which taxpayers now rest.

As discussed below, we do not agree with the Tax Court's holding that whether or not a given corporate distribution effects a distribution of earnings and profits, within the meaning of Sections 112 (c) (1) and (c) (2) of the Revenue Act of 1928, depends upon the total amount of gain reported by the individual stockholders as the result of the reorganization exchange (R. 26). We consider the correct rule to be that the nature and extent of the distribution is to be viewed from the standpoint of the corporation making the distribution, and not from that of the individual stockholders. Among the issues which the Tax Court may consider on remand, are: (a) whether the accumulated earnings (without regard to Crandall earnings and considering those of Henderson, Inc., alone), considering the purchase by New Corporation of 11,078 shares of its outstanding stock between December 4, 1928, and December 31, 1939, the liquidation or additional purchase of 12,805 shares in 1940, and the possibility of loss up to June, 1940, were sufficient to cover the June, 1940, distribution sought here to be taxed; (b) the extent to which the amount paid to Crandall stockholders (not participating in the reorganization)

in partial liquidation was, under the terms of Section 115 (c) of the Revenue Act of 1928, properly chargeable to capital account and did not constitute a distribution of earnings or profits; (c) if any sums are to be regarded as received by Crandall stockholders as "boot," whether its distribution effected a distribution of earnings and profits.

Thus, if this Court agrees with the Government's contention that, where there is a reorganization within the meaning of the nonrecognition provisions of the federal tax statutes, the introduction of new cash into the corporate picture does not prevent the application of the *Sansome* principle, then we believe that the appropriate disposition of these cases will be to remand them to the Tax Court, in order that a determination may be made whether the new company had sufficient earnings and profits, including such earnings as were transferred from the old corporations, to cover all or any part of the distribution of $35,166.25 made by the new corporation on June 19, 1940, which is in issue.

II

THE AVAILABILITY OF EARNINGS AND PROFITS

The Tax Court has held that all of the earnings of both of the old corporations were transferred to the new corporation (R. 27). The court below held that the *Sansome* principle is inapplicable

and that none of the earnings of the old corporations were transferred to the new (R. 44). If the *Sansome* rule applies to these cases, then, obviously, all of the Henderson, Inc., earnings were transferred to the new corporation, for Henderson, Inc., and its stockholders received only stock upon the reorganization. We believe it to be equally clear that at least some part of Crandall's earnings were transferred to the new corporation. In any event, the conclusion is possible in these cases that even if the earnings of Henderson, Inc., alone were transferred to the new corporation, there were sufficient available earnings and profits in the hands of the new corporation on June 19, 1940, to cover the entire distribution made by the new corporation on that date. To reach that conclusion, however, would require, as we shall point out hereinafter, a decision of several issues which have not been passed upon either by the Tax Court or the court below. Resolution of these issues will likewise determine to what extent, if any, Crandall's transferred earnings must be taken into account to produce an amount sufficient to cover the June 19, 1940, distribution which is in question.

A. EARNINGS AND PROFITS OF THE NEW CORPORATION, AVAILABLE FOR DISTRIBUTION ON JUNE 19, 1940, TAKING INTO ACCOUNT ONLY THE TRANSFERRED EARNINGS OF HENDERSON, INC.

The New Corporation, on June 19, 1940, distributed $35,166.25 to its common shareholders.

Out of this sum the taxpayers together received $25,000. (R. 21.) We think it clear that part of this $25,000, if not the whole, was made up of earnings and profits: *First:* Between December 4, 1928, the date of the reorganization, to December 31, 1939, the New Corporation had earnings and profits of $401,470.07, as against distributions of only $369,452.30. (R. 22.) This left earnings of $32,017.77, which had not been distributed as of January 1, 1940. The company lost $37,252.47 in 1940; and the extent to which this loss affected earnings available for the June 1940 distribution has not been determined (R. 46).

Second: Between December 4, 1928, and December 31, 1939, the New Corporation also acquired 11,078 shares of its own stock for $72,211.13. (R. 22.) This purchase probably did not diminish the New Corporation's earnings, for neither the stipulation nor the Tax Court's finding indicates that these shares were cancelled or redeemed and the record points to the conclusion that they were not. *Amelia H. Cohen Trust* v. *Commissioner,* 121 F. 2d 689, 691 (C. C. A. 3d); *Dow Chemical Co.* v. *Kavanagh,* 139 F. 2d 42 (C. C. A. 6th); *Fox* v. *Harrison,* 145 F. 2d 521 (C. C. A. 7th); *Aviation Capital* v. *Pedrick,* 148 F. 2d 165 (C. C. A. 2d), certiorari denied, 326 U. S. 723. The transaction merely marks the conversion of one asset, cash, into another kind of asset, stock, held for investment. The New Corporation issued 50,000 shares upon its organization and no

other shares were ever issued (R. 14). Nevertheless, in March 1940, there were 11,078 shares of treasury stock outstanding (R. 21). *Third:* The New Corporation, in 1940, "liquidated or purchased" 12,805 additional shares of its own stock for $94,441.90 in cash (R. 22). The Tax Court did not determine whether the sums expended in this purchase should be subtracted from accumulated earnings and profits (R. 22, note 1). The court below likewise regarded the question as to whether the sums expended (R. 42, note 3)—

> in liquidating purchases should be subtracted from accumulated earnings and profits. * * * unnecessary to the decision below and * * * not important to the result arrived at here.

This question, too, may appropriately be determined by the Tax Court on remand.

While at the time of the reorganization, $355,247.75 in cash was distributed, no part of this amount came out of Henderson's earnings. On the contrary, the Tax Court found that all the assets of Henderson, Inc., were acquired by the

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The additional stipulation that (R. 9):

> Crandall-McKenzie & Henderson, Inc., at December 31, 1939, had no earnings or profits accumulated from December 4, 1928, to December 31, 1939, and it had no earnings or profits in its taxable year January 1, 1940, to December 31, 1940—

certainly does not mean that there was any *deficit* in accumulated earnings and profits of Crandall-McKenzie and Henderson, Inc., on December 31, 1939. See further our main brief, p. 6, note 2.

New Corporation solely in exchange for 9,524 shares of its stock, and that, at the time of this acquisition, Henderson, Inc., had earnings and profits of $74,763.62 accumulated subsequent to March 1, 1913. (R. 21.) Hence, without regard to Crandall earnings and considering those of Henderson, Inc., alone, a question is presented for the trier of the facts, as the dissenting judge in the court below indicated (R. 44) and as we have shown above, to determine whether the accumulated earnings were sufficient to cover the June 1940 distribution. If found sufficient, as we contend they are, or to the extent that there were earnings and profits available, what the petitioners received were dividends in accordance with the *Sansome* doctrine.

B. EARNINGS AND PROFITS OF THE NEW CORPORATION, AVAILABLE FOR DISTRIBUTION ON JUNE 19, 1940, TAKING INTO ACCOUNT CRANDALL'S TRANSFERRED EARNINGS

The Tax Court thought that it was sufficient here that taxpayers had not proved that any of the Crandall stockholders had realized a gain (R. 26–27), which was taxed to them under Sections 112 (c) (1) or (c) (2) of the Revenue Act of 1928, quoted in the footnote.[3] While the

[3] Revenue Act of 1928, c. 852, [illegible] at. 791:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this

record clearly supports the Tax Court's statement as to failure of proof, we do not agree with its holding that, whether or not a given corporate distribution effects a distribution of earnings and profits, is dependent upon the circumstance of whether a particular stockholder may or may not have realized a gain in his individual case. Our view is that the answer depends upon the nature of the distribution viewed from the standpoint of the corporation making the distribution. The stockholders of a given corporation may have acquired their stock at various times and at various prices. Under Section 112 (c) (1), the gain realized is measured by taking the difference between the sum of the "boot" and the fair

section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection, but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

market value of the new stock received and the cost or other basis of the old shares. Under that Section, however, the realized gain is taxable only in an amount equal to the cash received, and under Section 112 (c) (2) such portion of the taxable gain as does not exceed the stockholders' ratable shares of the earnings and profits of the corporation is treated as a dividend. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283. It is clear that the total gain reported by all of the stockholders participating in the reorganization may have little relation either to the amount of cash distributed or to the amount of earnings and profits of the distributing corporation. Moreover, to make the question, whether earnings and profits of the distributing corporation have been carried over, depend upon the total amount of gain reported by the stockholders as the result of the reorganization exchange, would create grave administrative difficulties and impose hardships on the successor corporation subsequently declaring dividends. Indeed, the corporation might not be able to secure information from its stockholders or former stockholders as to the amount of gain realized on the reorganization. The conclusion must necessarily be that the extent to which the distribution of "boot" effects the distribution of earnings and profits should not be determined by reference to the amount of gain that has been taxed to stockholders, and instruc-

tions to that effect should be given to the Tax Court upon a remand.

Taxpayers have not shown that the distribution of cash incident to the acquisition of the Crandall assets by New Corporation resulted in a distribution of all of Crandall's accumulated earnings and profits. It will be recalled that New Corporation acquired the Crandall assets for 14,607 shares of its own and $355,247.75 in cash (R. 21), and the cash and shares were distributed to Crandall shareholders.

According to the contentions made by taxpayers in their brief, this transaction is to be analyzed as follows (pp. 4–5):

> The holders of 1017.5 shares of Crandall, par value $10.00 per share, out of a total of 2060 shares, received $355,217.75 in cash in full for their 1017.5 shares. The holders of the remaining 1042.5 shares of Crandall received the 14,607 new company shares (and $30.00 cash) in exchange for their shares. * * *.
>
> O. McKenzie received 12,181 shares of the new company in exchange for 842½ shares of Crandall or 14.46 shares for one and J. L. Brown and A. J. Kapp each received 1,213 shares of the new company plus $15.00 for 100 shares of Crandall or 12.13 shares plus 15 cents for one. (R. 13–14.)
>
> A. E. Crandall received $300,000 in cash for 842½ shares of Crandall, or $356.00 plus per share and the holders of the re-

> maining 175 shares of Crandall received cash at the rate of $315.53 per share, as to 25 shares by sale to the new company and as to 150 shares from the liquidating trustees of Crandall. (R. 22, 12, 13.)

Hence, the effect of this analysis by taxpayers is that the only stockholders of Crandall who participated in the reorganization were Kapp and Brown and O. McKenzie, for they alone received shares of New Corporation stock in exchange for their Crandall shares; on the other hand, the remaining Crandall stockholders received only cash for their Crandall shares and in the aggregate amount of $355,217.75. Thus, the latter did not participate in the reorganization, and insofar as they were concerned there was a distribution in partial liquidation (Section 115 (h) of the Revenue Act of 1928) on which they were taxable as on a gain from a sale (Section 115 (c) of the Revenue Act of 1928). The extent to which such a partial liquidation effected a distribution of earnings and profits depends upon Section 115 (c) which, as shown in the footnote,[4] provides that the

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[4] Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under

portion of a distribution in partial liquidation properly chargeable to capital account is not to be considered a distribution of earnings and profits for the purpose of determining the taxability of subsequent distributions.

Moreover, in *Jarvis* v. *Commissioner*, 43 B. T. A. 439, affirmed, 123 F. 2d 742 (C. C. A. 4th), the Board of Tax Appeals and the Circuit Court of Appeals held that the amount of distribution in partial liquidation that is properly chargeable to capital account, is not only the par value of the shares redeemed, but also the paid in surplus chargeable to that stock and that only the balance of the distribution is chargeable to earnings.

Taxpayers in their brief (p. 13) completely fail to take this principle into account in the argument which they make with regard to the effect of the payment of cash in the amount of $355,217.75 (stated by taxpayers as $355,245.72) to the holders of 1017½ shares of Crandall stock. The principle represented by the *Jarvis* case should be applied here. It is true that the record indicates

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section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

that the 1017½ shares of Crandall had a par value of $10,175 (R. 9), but the record further establishes that Crandall had a large paid in surplus. Thus, New Company paid the amount of $649,991.80 according to its own valuation for assets of Crandall alone. (R. 12–13.) All of Crandall's 2060 shares represented a par value of $20,600. Its earned surplus, as has been seen, was $329,267.95. The difference between the sums of these amounts and $649,991.80 is in excess of $300,000. Besides, the distribution of earnings by the partial liquidation was not to 100% of Crandall stockholdings but to less than 50%, and hence only a proportionate part of the accumulated earnings and profits would be deemed distributed under Section 115 (c), i. e., no more than approximately $162,000. It appears therefore that a large part of the distribution to the dissenting stockholders necessarily represented a distribution of capital and paid in surplus and only part of the earnings. Thus, taxpayers have not established that even in the case of Crandall, the accumulated earnings were distributed prior to the June 1940 distribution here sought to be taxed.

Finally, if the analysis made by taxpayer of the Crandall distribution is not accepted by the Court, and it is deemed that A. E. Crandall had no part in the reorganization and that the $300,000 was paid to O. McKenzie together with 12,181

shares of New Corporation stock for 1,685 Crandall shares, 842½ of which he had independently purchased from A. E. Crandall, and hence, that the receipt of the $300,000 by McKenzie is to be considered "boot" under Section 112 (c) (1) and (c) (2) of the Revenue Act of 1928, it is our position that this distribution did not effect a distribution of earnings and profits to any extent, because it was not made pro rata. The situation is totally different from that involved in *Campbell* v. *United States, supra*, where the distributions were pro rata and the Court held as a second ground of decision that the earnings had been distributed in the reorganization. Further, even under this view of the facts, Ayer and Hasson and 104 other Crandall stockholders received no "boot" on an exchange of stock for stock, but were simply paid $55,217.75 for their shares in partial liquidation.* The extent to which such a transaction in partial liquidation effected a distribution of earnings and profits under Section 115 (c) of the Revenue Act of 1928 has already been discussed. Thus, on this view of the record also, the respondents have not established that earnings were distributed at the time of the reorganization.

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*The New Corporation purchased the Ayers and Hasson stock at $315.53 a share for $7,888.25 (R. 11–12) and the remaining 150 shares of Crandall stock belonging to 104 stockholders for $47,329.50 (R. 12–13).

CONCLUSION

The second ground of decision in the *Campbell* case certainly is not dispositive of the instant case, and this Court should decide this case, as did the court below, on the sole issue presented in the petition for certiorari, namely, the applicability of the *Sansome* rule to a situation in which new stockholders acquired for cash a stock interest in the successor corporation with consequent change in the proportionate interest of the old stockholders in the enterprise. The case, accordingly, should be remanded to the Tax Court with proper instructions. See *supra*, pp. 10–13.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

NOS. 674 AND 675

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIDNEY S. MUNTER.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CARL MUNTER.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENTS.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

NO. 674.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIDNEY S. MUNTER.

NO. 675.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CARL MUNTER.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENTS.

OPINIONS BELOW.

The opinion of the Tax Court (R. 20-29) is reported in 5 T. C. 108, and the opinion of the Circuit Court of Appeals (R. 41-46) is reported in 157 F. 2d 132.

JURISDICTION.

The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended.

STATEMENT OF THE QUESTION.

A new corporation was formed in 1928 to acquire the business of two existing corporations. A majority of the new company's stock was sold to new interests for cash. The new company acquired the assets of the old companies in exchange for the remaining shares (a minority) of the new company and about 75 percent of the cash supplied by the new interests. This cash, paid to some of the shareholders of the larger predecessor, was more than the earnings and profits of the larger predecessor but less than the combined earnings and profits of both predecessors. The new corporation made a distribution to its shareholders in 1940, when it had no earnings or profits of its own. The question is whether the 1928 distribution to old shareholders of cash contributed by new shareholders precludes treatment of the earnings of both predecessors as earnings of the new company available for distribution as a 1940 dividend.

STATEMENT OF THE CASE.

The proceedings are for review of decisions of The Tax Court of the United States determining deficiencies in income taxes for the calendar year 1940 in the respective amounts of $8,175.50 and $9,596.33.

On March 21, 1940 each of the respondents acquired by purachse from O. McKenize at the price of $8.00 per share 10,000 shares of the capital stock of Crandall-McKenzie & Henderson, Inc., a Pennsylvania corporation, out of a total of 38,922 shares issued and outstanding (exclusive of 11,078 shares of treasury stock) at the price of $8.00 per share. (R. 8-9; 21)

On June 19, 1940, Crandall-McKenzie & Henderson, Inc. distributed to its shareholders cash in the amount $35,166.25 at the rate of $1.25 per share of which each respondent received $12,500 with respect to the 10,000 shares held by him. (R. 9, 21)

Crandall-McKenzie & Henderson, Inc. at December 31, 1939 had no earnings or profits accumulated from December 4, 1928 to December 31, 1939, and it had no earnings or profits in its taxable year January 1, 1940 to December 31, 1940. (R. 9, 21)

The respondents treated the 1940 distribution as a non-taxable return of capital under section 115(d) of the Internal Revenue Code. The petitioner included it in income as a dividend out of earnings and profits acquired from predecessor corporations in 1928. The Tax Court sustained the petitioner's determination, with a dissenting opinion by Disney, J. (R. 20, 27) On review, the Circuit Court of Appeals reversed the Tax Court (R. 41, 47), with a dissenting opinion by O'Connell, C. J. (R. 44)

Crandall-McKenzie & Henderson, Inc. (new company) had been formed in December, 1928 pursuant to an agreement between K. W. Todd & Company, investment bankers, and O. McKenzie and L. Henderson, shareholders of two corporations, Crandall-McKenzie Company and L. Henderson & Sons, Inc. (the old companies). Upon consummation of the December, 1928 transaction the new company had acquired substantially all the assets of the old companies in exchange for 24,131 shares of capital stock of the new company and $355,247.75 in cash and the remaining 25,869 shares in the new com-

pany had been issued to new interests for cash in the amount of approximately $486,893.92. (R. 21)

All the assets of one of the old companies, L. Henderson & Sons, Inc., were acquired by the new company in the 1928 transaction solely in exchange for 9,524 shares of the new company. At the time of this transaction L. Henderson & Sons, Inc. had earnings and profits of $74,743.62 accumulated subsequent to March 1, 1913. (R. 21)

The assets of the other old company, Crandall-McKenzie Company (for convenience called "Crandall"), were acquired by the new company in the 1928 transaction in exchange for 14,607 shares of the new company and $355,247.75 in cash. The holders of 1017.5 shares of Crandall, par value $10.00 per share, out of a total of 2060 shares, received $355,217.75 in cash in full for their 1017.5 shares. The holders of the remaining 1042.5 shares of Crandall received the 14,607 new company shares (and $30.00 cash) in exchange for their shares. At the time of this transaction Crandall had earnings and profits accumulated subsequent to March 1, 1913, in the amount of $329,267.95. (R. 11-14; 21)

O. McKenzie received 12,181 shares of the new company in exchange for 842½ shares of Crandall or 14.46 shares for one and J. L. Brown and A. J. Kapp each received 1,213 shares of the new company plus $15.00 for 100 shares of Crandall or 12.13 shares plus 15 cents for one. (R. 13-14)

A. E. Crandall received $300,000 in cash for 842½ shares of Crandall, or $356.00 plus per share and the holders of the remaining 175 shares of Crandall received cash at the rate of $315.53 per share, as to 25 shares by

sale to the new company and as to 150 shares from the liquidating trustees of Crandall. (R. 22, 12, 13)

The sole question is whether under the undisputed facts the new company, on its organization in 1928, acquired the earnings and profits of both old companies as its earnings and profits.

ARGUMENT.

Summary of Argument.

The decisions of the Circuit Court of Appeals for the Third Circuit in *Campbell v. U. S.*, 144 F (2d), 177 and in this case are correct. They are not in conflict, either in principle or on their facts, with any decision cited by the petitioner.

It is not necessary for this Court to decide in this case whether the circumstance of transfer in reorganization to a new corporation controlled by new interests is alone sufficient to justify conversion of predecessor earnings into transferee capital. Nor is it necessary to decide whether such circumstance is sufficient to prevent operation of the tax-free reorganization provisions of the governing statutes. Doubting that the 1928 transaction would meet the tests of the decisions of this Court, counsel for the respondents merely assume, without admitting, that the 1928 transaction was tax-free to those shareholders who received stock for stock. The real question is whether the transfer of control to new interests, largely for cash, accompanied by distribution of the cash to transferor shareholders, precludes application of the rule of transfer of earnings in reorganization. The Circuit Court decision does not rest solely

on the lack of identity of proprietary interest, as argued by the petitioner. On the contrary it rests squarely on the effect of the 1928 cash transactions.

The 1928 transaction in the present case was more of the nature of a cash purchase than a reorganization, with the result that more than the entire earnings of the larger predecessor were distributed in cash to its shareholders in 1928. The same earnings cannot be distributed a second time in 1940. The 1928 transaction, whether or not it was a reorganization, was not tax-free to the shareholders who received cash for their shares. On the contrary, their gain would be recognized in full.

The *Sansome* rule, about which the petitioner is so gravely concerned, is not violated by the Circuit Court decision in this case. That rule, and the statutes on which it is based, are designed to prevent conversion of earnings into capital in situations where there is a tax-free intercorporate exchange of *assets for securities*. The statutes do not include sales for cash in the tax-free provisions. Cash payments to shareholders in reorganization give rise to gain recognizable to the full extent of the cash and constitute distributions of earnings and profits. The Tax Court missed this point and thus failed to reach the inevitable conclusion that the 1928 distribution of cash was out of earnings and profits.

The majority of the Circuit Court held that separate treatment of the earnings of Henderson, the smaller predecessor, not distributed in cash in 1928, is not justified because the "reorganization" of both predecessors was a single transaction. The dissenting Judge in the Circuit Court, conceding that Crandall's earnings were "possibly" distributed in 1928, concluded that Henderson's earnings were transferred tax-free in reorganiza-

tion and suggested remand for determination whether Henderson's earnings alone were sufficient to cover the disputed 1940 distribution. The facts from which this determination could be made are in the record, and the point was argued to the Tax Court. It must be assumed that the Tax Court concluded that Henderson's earnings alone were not sufficient, making it necessary in sustaining the tax to include Crandall's earnings.

The governing statutes and regulations do not permit any doubt that the 1928 cash distribution was out of earnings. The Tax Court decision is clearly contrary to the law and the decision of the Circuit Court of Appeals should be affirmed.

The "Sansome" rule does not apply to distributions of money in reorganization.

The *Sansome* case (60 F. (2d) 931) was decided in 1932 under the Revenue Act of 1921. (42 Stat. 228) It merely held that, for income tax purposes, earnings of one corporation do not become capital of another in a case where the old and the new corporations are identical. The Courts have uniformly held, under all later Revenue Acts, that earnings of one corporation do not become capital of another in comparable situations, where on reorganization all shareholders of the transferor corporation or corporations receive *only* securities of the transferee corporation. In none of the cases cited by the petitioner was there in the "reorganization" a purchase by a transferee corporation out of cash capital contributed by new controlling interests of the transferee corporation, accompanied by a distribution of cash to shareholders of a transferor. There is therefore no need to discuss the cases cited by the petitioner.

There is statutory basis for this rule in Section 203(g) of the Revenue Act of 1924, 43 Stat. 253, (Appendix page 17); Section 112(h) of the Revenue Act of 1928, 45 Stat. 791 (Appendix page 22); Section 112(h) of the Revenue Act of 1932, 47 Stat. 169 (Appendix page 26); Section 115(h) of the Revenue Act of 1934, 48 Stat. 680 (Appendix page 27); Section 115(h) of the Revenue Act of 1938, 52 Stat. 447 (Appendix page 28); and Section 115(h) of the Internal Revenue Code (Petitioner's brief page 39).

As explained in Congressional reports, prior to the 1924 Act some distributions of securities in reorganization were taxable as dividends and affected availability of earnings for future distribution. Section 203(c), Revenue Act of 1924 (Appendix page 17), Report of Ways and Means Committee, 68th Congress, 1st Session, H. Rept. 179, pages 14 and 16 (Appendix page 17).

All of the statutes prior to the 1938 Act related only to distributions of stock or securities. Section 115(h) of the 1938 Act included "money" received without recognition of gain:

"In view of the fact that Sections 112(b)(6) and (), permit the distribution of property (including money) in addition to stock or securities, without the recognition of gain to the distributee, * * *." (75th Congress, 3rd Session, S. Rept. 1567, page 19; see also change with respect to money in 112(b)(6), Appendix pages 27 and 28).

The distinction, in treatment of money, between reorganizations on the one hand and liquidations on the other appears clearly in Section 19.115-11 of the regulations printed in full in the appendix to this brief (Pages

37 to 40). Paragraphs (2), (3) and (4) should be read in connection with petitioner's statement on page 21 of his brief that the words "property or money" were added after the phrase "stock or securities." The statutory sanction of the *"Sansome"* rule on which petitioner relies does not, therefore, apply to distributions of money in connection with a reorganization.

There is no statute, regulation or decision under which a distribution of money in connection with a reorganization, is not recognized as a distribution of earnings or profits of a corporation.

The decision of the Circuit Court rests on the 1928 cash transactions.

The decision of the Circuit Court of Appeals in this case does not rest "solely on the lack of identity of proprietary interest" nor on "the mere fact that new stockholders acquire for cash a stock interest in the successor corporation" as argued by the Government. (Petitioners' brief, pp. 26-27) The Circuit Court explains the grounds of its decision as follows: (R. 44)

> "As seen the new corporation not only differed radically from its two predecessors but actually paid out in cash to one of them more than the latter's earnings and profits though less than the combined earnings and profits of both old corporations * * *"

The vital facts so tersely summarized cannot be disputed. Based on the stipulation of the parties (R. 9-14), the Tax Court found (R. 21):

> In 1928 the new corporation "acquired all the assets of the two named predecessor corporations

in exchange for 24,131 shares of its capital stock and $355,247.75 in cash. This stock and cash were received by stockholders of the two predecessor companies for their stock therein. The remaining 25,869 shares in the new company were issued to new interests for cash in the amount of approximately $486,893.92. • • •

"The assets of (Crandall) the other predecessor corporation • • • were acquired by the new company, Crandall-McKenzie, for 14,607 shares of its stock and $355,247.75 in cash. At the time of this transaction Crandall had earnings and profits accumulated subsequent to March 1, 1913 in the amount of $329,267.95." The other predecessor (Henderson) whose shareholders received no cash, had accumulated earnings and profits of $74,743.62. The combined post 1913 earnings and profits of both old corporations were $404,011.57 and shareholders of the one received $355,247.75 in cash from the new corporation.

Under these circumstances, the new corporation was so different from the old as to preclude any idea of transferred earnings.

The tax Court missed the point.

The Tax Court missed the point inherent in these facts. It correctly concluded that in the 1928 transaction "the participating stockholders of the old corporations exchanged their stock in the old corporations for stock in the new company and money." (R. 2) But it failed to follow through with the conclusion that the money constituted a distribution of the earnings and profits of the old companies. After pointing out that

recognizable gain is a prerequisite to a distribution of a taxable dividend (earnings), it stated that the record is lacking in proof of the cost of the old stock in the hands of the stockholders who received the cash so that it could not determine the *amount* of the gain. (R. 26) On this reasoning it found that the earnings of both predecessor corporations were taken over in toto by the new corporation. (R. 27)

The point which the Tax Court missed is that the tax nature of a corporate distribution is determined from the point of view of the distributing corporation, rather than of the distributee shareholders. The governing statutes and regulations require the conclusion that the 1928 cash payments constituted a distribution of earnings and profits, regardless of the cost of the shares in the hands of the distributee shareholders.

A shareholder who on reorganization of a corporation receives cash for his interest is party to a taxable transaction, whether or not the gain of other shareholders is recognized on an exchange of stock for stock in the same transaction. As between the distributing corporation and the non-participating shareholder who receives cash, there is a distribution of earnings and profits.

Crandall's earnings were distributed in cash in 1928.

On the Government's own theory of the case, the issue narrows down to the question whether the 1928 cash distribution was a distribution of earnings or profits. There is no discussion of this point in the Government's brief other than the statement (footnote p. 25)

that the "Tax Court assumed, in the absence of proof to the contrary, that the Crandall stockholders realized no gain."

The question is not whether a particular shareholder realized gain, but rather whether gain (if any) on the transaction is *recognizable* in law. Thus it does not matter how much the particular shareholder paid for his shares. The taxable character of the transaction is determinable without proof of the cost to Crandall and the other non-participating shareholders. The gain, if any, to them is *recognized* in full, because they received only cash for their shares.

If the 1928 transaction was a reorganization, the cash distribution to Crandall shareholders, to the extent of the accumulated earnings and profits of the old company, had the effect of the distribution of a taxable dividend. *Revenue Act of 1928*, Sec. 112 (c) (1) and (2); *Commissioner v. Estate of Bedford*, 325 U.S. 283; *Estate of John B. Lewis v. Commissioner*, 6TC 455.

If the 1928 transaction was not a reorganization and the cash distribution to the retiring shareholders of Crandall was in complete or partial liquidation of the old company, the part of the distribution not properly chargeable to capital account must "be considered a distribution of earnings or profits * * * for the purpose of determining the taxability of subsequent distributions by the corporation." *Revenue Act of 1928*, Sec. 115 (c) (Appendix p. 25); *Reg. 103*, Sec. 19.27 (g) (Appendix p. 35); *Reg. 103*, Sec. 19.115-2 (Appendix p. 33); *Reg. 103*, Sec. 19.115-11 (Appendix p. 37); *Helvering v. Jarvis*, 123 F. (2d) 742; *Helvering v. Credit*

Alliance Corp., 316 U.S. 107; *Commissioner v. Sansome*, 60 F.(2d) 931; compare *Foster v. U. S.*, 303 U.S. 118.

The record shows that the holders of 1017½ shares of old company stock receiving cash of $355,245.75. (R. 11-14). The par value of these shares was $10,175.00. (R. 9) The earnings and profits accumulated before and after March 1, 1913 were $345,298.49. (R. 14) It is clear that the distribution to the old shareholders exhausted all capital allocable to their shares ($10,175.00) and all Crandall's accumulated earnings.

Paraphrasing the statement of Disney, J., in the dissenting opinion of the Tax Court, (R. 28) the result here is the same as if the old company kept its earnings and profits and paid them out to its own shareholders. The new company would then have retained the cash capital contributed by the new shareholders and the payment here in dispute would clearly be from that cash capital.

Separate treatment of Henderson's earnings.

The Tax Court in its opinion did not discuss the possible result of the transfer to the new corporation, *qua* earnings, of the earnings of the smaller predecessor, L. Henderson and Sons, Inc. The possibility is discussed in the dissenting opinion of O'Connell, C. J. (R. 46)

The record shows and the Tax Court found, that the cash of $355,247.75 was received in 1928 by Crandall stockholders for their Crandall stock. (R. 21) This fact is admitted by the petitioner. (Pet. brief, p. 5) This cash exceeded the earnings of Crandall, the larger predecessor. (R. 21, Pet. brief, p. 5) Henderson shareholders

received only shares of the new company and Henderson had earnings of $74,743.62.

The majority of the Circuit Court of Appeals concluded that separate treatment of Henderson's earnings would serve no purpose, and is not justified, in a single transaction reorganization where "only the total earnings and profits arrived at upon its conclusion appears pertinent." (R. 42, footnote 2) Holding to the contrary, the dissenting Judge concludes that Henderson's earnings were transferred to the new company, and suggests remand to the Tax Court to determine whether enough Henderson earnings were still on hand to cover the 1940 distribution. (R. 46)

The stipulation of facts was drawn in anticipation of this question. The parties agreed on the facts which they considered essential to its determination in paragraphs 3 (R. 9) and 10 (R. 14) of the stipulation. Resolving the question of the effect on earnings of the acquisition of the corporation's own shares, the parties agreed in paragraph 3 that there were no earnings on hand "accumulated from December 4, 1928 to December 31, 1939." (R. 9) On the same theory, paragraph 10 of the stipualtion (R. 14) supports the conclusion (as argued on brief to the Tax Court) that what may have been left of Henderson's earnings at December 31, 1939 was distributed and lost in 1940 without considering the June, 1940 distribution.

There is no logical alternative to the assumption that the Tax Court did consider the possible result of the transfer to the new company of Henderson's earnings without transfer of Crandall's earnings.

It is also logical to assume from the result either that the Tax Court found it necessary, in sustaining the tax, to include Crandall's earnings, or that the Tax Court viewed the reorganization as a single transaction.

The Tax Court's conclusion disregarded the facts.

Aside from the fact that the shareholders of the predecessor companies acquired less than a majority of the shares of the new company, the case is controlled by the fact that the new company had, prior to 1940, distributed all of the accumulated earnings of the predecessor companies. This fact is implicit in the Tax Court's findings that:

(a) The new company acquired all the assets of the predecessors "in exchange for 24,131 shares of its capital stock and $355,247.75 in cash"; (R. 21)

(b) This stock and cash were received by stockholders of the predecessors in exchange for their stock therein; (R. 21)

(c) The stockholders of the old corporations exchanged their stock in the old corporations for stock in the new company and money; (R. 22)

(d) The cash which was paid to shareholders of Crandall ($355,247.75) exceeded its earnings and profits; (R. 21) and in the admitted facts that

(e) All except $30.00 of this cash was in full payment in exchange for 1017½ shares of Crandall

stock, par value $10.00 per share (R. 11-14, petitioner's brief, page 5.)

(f) The new company in 1940 had no accumulated earnings or profits of its own (R. 9) and

(g) The new company in 1940 distributed to its shareholders (excluding the disputed distribution) more than the amount of the 1928 earnings and profits of Henderson. (R. 14, 21, 22).

The applicable and governing statutes and regulations require the conclusion that the 1940 disputed distribution was a return of capital under Sec. 115 (d) of the Internal Revenue Code. The decision of the Circuit Court of Appeals should therefore be affirmed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1924, c. 234, 43 Stat. 253:

SEC. 203. RECOGNITION OF GAIN OR LOSS FROM SALES AND EXCHANGES.

* * * * * * *

(c) If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

* * * * * * *

(g) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of subdivision (b) of section 201 for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * * * *

Report of Ways and Means Committee, 68th Congress, 1st Session, H. Rept. 179:

page 14—

There is no provision of the existing law which corresponds to subdivision (c). Under the existing law, if corporation A organizes a subsidiary, corporation B, to which it transfers part of its assets

in exchange for all the stock of corporation B, and distributes the stock of corporation B as a dividend to its stockholders without the surrender by the stockholders of any of their stock, then such a dividend is a taxable one. If, however, corporation A organizes two new corporations, corporations B and C, and transfers part of its assets to corporation B and part to corporation C, and the stockholders of corporation A surrender their stock and receive in exchange therefor stock of corporations B and C, no gain from the transaction is recognized. Thus, under the existing law, the same result, except as to tax liability, may be obtained by either of two methods; but if the first method set out above is adopted, the gain is taxable, while if the second method set out above is adopted, there is no taxable gain. Subdivision (c) of the bill permits the reorganization to be accomplished in the first manner set out above without the recognition of gain. This method represents a common type of reorganization and clearly should be included within the reorganization provisions of the statute as long as the exemption under the present law is continued.

page 16—

There is no provision of the existing law which corresponds to subdivision (g). This subdivision provides that a distribution by a corporation in connection with a reorganization of stock or securities in another corporation, a party to the reorganization, shall not be considered a distribution of earnings and profits for the purpose of determining the taxability of subsequent distributions by the corporation.

It should be noted that this subdivision covers the case in which A distributes the stock of B as a dividend, the case in which A distributes the stock of B in retirement of a portion of its (A's) stock, and the case in which B issues its stock direct to A's stockholders in the course of a reorganization.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(b) *Adjustment of basis.*—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item, properly chargeable to capital account, and

* * * * * * *

(3) In the case of stock the basis shall be diminished by the amount of distributions previously made in respect of such stock, to the extent provided under the law applicable to the year in which the distribution was made.

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of money received plus the fair market value of the property (other than money) received.

(d) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of

the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913 The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(d) *Same — gain of corporation.* — If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not

only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

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(g) *Distribution of stock on reorganization.*— If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

(h) *Same — effect on future distributions.* — The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining the taxability of subsequent distributions by the corporation.

(i) *Definition of reorganization.* — As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(j) *Definition of control.* — As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.* — The basis for determining the gain or loss

from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * * * *

(b) *Property acquired before March 1, 1913.* —The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be:

(1) the cost of such property (or, in the case of such property as is described in subsection (a) (1), (4), (5), or (12) of this section, the basis as therein provided), or

(2) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.* — The term "dividend" when used in this title (except in section 203(a) (4) and section 208(c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.* — For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in

value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.* — Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112(h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

(d) *Other distributions from capital.* — If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 113, and if in excess of such

basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. The provisions of this subsection shall also apply to distributions from depletion reserves based on the discovery value of mines.

* * * * * * *

(h) *Definition of partial liquidation.* — As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(h) *Same—Effect on future distributions.*— The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, if no gain to the distributee from the receipt of such stock or securities was recognized by law, shall not be considered a distribution of earnings or profits within the meaning of section 115(b) for the purpose of determining the taxability of subsequent distributions by the corporation.

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Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(b) *Exchanges solely in kind.* — (Added by Sec. 110(a), Revenue Act of 1935, c. 829, 49 Stat. 1014.)

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(6) *Exchange in liquidation.*—No gain or loss shall be recognized upon the receipt by a corporation of property (other than money) distributed in complete liquidation of another corporation,

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SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

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(h) *Distribution of stock on reorganization—Effect on future distributions.*—The distribution before January 1, 1934, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, if no gain to the distributee from the receipt of such stock or securities was recognized by law, shall not be considered a distribution of earnings or profits within the meaning of this section for the purpose of determining the taxability of subsequent distributions by the corporation. As used in this subsection, the terms "reorganization" and "party to the reorganization" shall have the meanings assigned to such terms in section 112 of the Revenue Act of 1932.

Revenue Act of 1936, c. 690, 49 Stat. 1648.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(b) *Exchanges solely in kind.*—

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(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation.

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Revenue Act of 1938, c. 289, 52 Stat. 447.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

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(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, or stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, * * *

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Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(g) *Definition of reorganization.*—As used in this section (other than subsection (b) (10) and

subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquistion by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

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SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.* — The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to

insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.* — For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distribution in Liquidation.* — Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribu-

tion to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

(d) *Other Distributions From Capital.* — If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *

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(i) *Definition of Partial Liquidation.* — As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

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Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.112(g)-1. *Purpose and scope of exception of reorganization exchanges.* * * *

Purpose: Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization pro-

visions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and other securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, these specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer

to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

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SEC. 19.112(g)-2. *Definition of Terms.* — The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112(g)(1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange. * * *

SEC. 19.115-2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first*, to the earnings or profits of the taxable year; *second*, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third*, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings

or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth*, to sources other than earnings or profits only after the earnings or profits have been distributed.

* * * The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.

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SEC. 19.115-5. *Distributions in liquidation.*

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(c) *Partial liquidation.*—

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The term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accom-

plished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115(b) for the purpose of determining taxability of subsequent distributions by the corporations. (See sections 19.27(g)-1 and 19.115-11.)

SEC. 19.27(g)-1. *Dividends paid credit for distribution in liquidation.*

(2) *Distributions which diminish earnings or profits.* — * * * Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Code as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

(1) Under the provisions of section 115(c), the amounts distributed in liquidation are treated as received in payment in exchange for the stock; and

(2) Under the provisions of section 112, the gain or loss, if any, from such exchange is recognized * * *.

In such a case, an allowance for dividends paid may be included in the basic surtax credit for the amount actually involved in such distribution which is prop-

erly chargeable to the earnings or profits accumulated after February 28, 1913, even though the method of taxation of the distribution is that ordinarily employed with respect to the gain or loss realized and recognized upon an exchange, rather than that employed with respect to a taxable dividend.

On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Internal Revenue Code, not as distributions to the shareholders of earning or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Code as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Code. No allowance for dividends paid is permissible with respect to such transactions.

(b) *Amount properly chargeable to earnings or profits.* —

In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (a) of this section) the amount of the allowance is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the

amount of the distribution that part allocable to capital account. The capital account, for purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913.

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SEC. 19.115-11. (as amended by T. D. 5299, 1943-1 Cum. Bull. 747) *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

If a transaction described in the preceding paragraph has occurred, there shall be included in the accumulated earnings and profits of the trans-

feree corporation as of the day on which such transaction occurred the proportionate part of any earnings and profits of the transferor corporation accumulated as of such day and properly allocable to the transferee; and there shall be included in the current earnings and profits of the transferee for the taxable year of the transferee in which such transaction occurred the proportionate part of the earnings and profits of the transferor accumulated after the beginning of such taxable year and properly allocable to the transferee. The amount so included in the current earnings and profits of the transferee shall not exceed such proportionate part of the earnings and profits of the transferor accumulated as of the day on which such transaction occurred.

The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in ex-

change for its stock or securities (see section 112(b)(3)) if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money to a corporation in complete liquidation of another corporation, under the circumstances described in section 112(b)(6) of the Revenue Act of 1936; or of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) of stock or securities, or other property or money, in the case of any exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for

distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), (3), or (4) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Actof 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1946

NOS. 674 AND 675.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIDNEY S. MUNTER.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CARL MUNTER.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

REPLY BRIEF FOR THE RESPONDENTS.

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On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

REPLY BRIEF FOR THE RESPONDENTS.

The real question in the case.

The question presented in the petition for writs of certiorari (p. 2) and in the petitioner's brief (p. 2) namely, whether the "Sansome" rule applies where new stockholders acquire for cash a stock interest in the successor corporation, is not the real question in the case. The question as stated by the Government would apply where new stockholders acquired a small minority

interest. The real question is whether the payment of cash by new interests for *control* of a new corporation, formed solely to acquire the businesses of the predecessors, precludes application of the "Sansome" doctrine. Regardless of how the Circuit Court of Appeals stated its reasons, its decision was correct. That decision should be affirmed and the "Sansome" rule should not be extended to apply to a new corporation, formed solely to acquire the businesses of two existing corporations, where entirely new interests pay cash for their controlling interest in the new corporation and that cash is largely used to buy predecessor assets.

The Government's position.

The Government's position in this case is elusive. The Tax Court sustained the Government's position that the earnings of both predecessors became the earnings of the successor, *in toto*. (R. 27) The Tax Court refused to follow *Campbell v. U. S.*, 144 F (2d) 177, because of failure of proof of gain realized by shareholders who received cash. (R. 26-27) The Government argued that this holding was correct, not only before the Circuit Court of Appeals, but also in its main brief in this Court. (Petitioner's brief, pp. 25-27, especially footnote p. 25) The Government now disagrees with this holding and asks that this Court so instruct the Tax Court upon a remand. (Reply brief for the petitioner, pp. 5-6, 10-13) The Government thus adopts the argument of the respondents. (Brief for the respondents, pp. 10-11)

Up to the time of the oral argument before this Court it was the Government's position that the earn-

ings of both predecessors became the earnings of the successor, *in toto*. It was another effort by the Government to have the "Sansome" rule declared applicable to every "reorganization," as had been argued in the *Campbell* case. (Petitioner's brief, p. 31) The Government now shifts its position and argues for a remand to determine whether *part* of the earnings of the predecessors became the earnings of the successor. While so doing, it urges this Court to decide in its favor the question presented by it in the petition for certiorari. (Reply brief for petitioner, p. 5)

The main argument of the Government is based on separation into two parts (called two exceptions to the "Sansome" rule) of the reasoning of the Circuit Court of Appeals in the *Campbell* case. The Government apparently fears that the so-called "first exception" might be separately applied in some other case. The Government in effect asks this Court to reverse part of the reasoning of the Circuit Court of Appeals, torn from its setting in the facts and in the overall reasoning.

Regardless of how the Circuit Court stated its reasons, its conclusion in this case was right. The purpose of the Government would be served if this Court, in affirming the decision below, were to say that the decisions of the Circuit Court of Appeals in *Campbell v. U. S.*, 144 F (2d) 177, and in this case do not necessarily apply in every reorganization where new stockholders acquire for cash a stock interest in the successor corporation.

The case need not be remanded.

The petition for certiorari and the Government's main brief really argued that the "Sansome" rule applies to *every* transfer in reorganization, with the result that transferor earnings become transferee earnings *in toto*. (Petition, p. 7, petitioner's brief, p. 26) General application of such a rule would lead to absurdities, as clearly stated in Mertens, Vol. 1, Sec. 9.58, pp. 509, 510, as follows:

> "It has been implied, however, that the general principle of 'inherited' earnings or profits applies wherever there is a 'nontaxable' reorganization. It may be misleading, however, to state its scope in such general terms. Assuming that the provision in the statute taxing corporate distributions of 'its earnings or profits' is capable of requiring the inclusion of the earnings or profits of predecessor corporations, it would still seem to be necessary to draw distinctions based on the type and character of the reorganization in each case. Possibly a different conclusion may be applicable where there has been merely an exchange by the parent corporation of its *stock for stock* of the subsidiary in a tax-free reorganization than applies in a case in which the reorganization involves the acquisition by the new company of the old company's *assets* with other substantial changes in the corporate structure. The test should not be the 'tax-free' character of the so-called reorganization; any such general test would confuse the issue and give rise occasionally to absurd results in the various types of situations arising under our complex exchange and reorganization provisions. The proper

test is whether there is substantial identity of the several corporations and continuity of proprietary interest."

The Government, admitting that the Tax Court decision was wrong, now desires remand for determination whether *part* of the predecessor earnings became the earnings of the successor.

Respondents submit that the Circuit Court of Appeals correctly decided that no part of the earnings of the predecessors be treated as the earnings of the successor, on the grounds assigned by it (R. 42-44) and by Disney, J., in the dissenting opinion of the Tax Court (R. 27-29). The decision below is correct also for the following reasons:

(a) The 1928 transaction was not multiform, but single. Separate treatment of Henderson earnings is not justified.

(b) This is not a case of tax avoidance. The successor was a new venture by new shareholders who paid cash for their shares. Although the business of the predecessors became the business of the successor, the new corporation *purchased* the assets of the predecessors in a single transaction. The cash paid in to the new corporation by the controlling shareholders was capital. Neither this cash nor any predecessor earnings should be treated as successor earnings. Tax avoidance is not present where control shifts to new interests for cash.

(c) The "Sansome" rule disregards for tax purposes the effect of State law by treating corporate capital as earnings where transferors receive se-

curities of the transferee. Compare *Ogilvie Hardware Co. v. Commissioner,* .... U.S. ...., decided April 7, 1947. It should not be extended to apply in a situation where a new corporation is organized by new controlling interests who contribute cash which is used largely to purchase predecessor assets. Retention by predecessor shareholders of a minority interest in the new corporation formed solely to acquire the businesses of the predecessors, in a single transaction, does not justify or require application of the "Sansome" rule to any part of the earnings of either of the transferors.

(d) The 1928 transaction in this case was more in the nature of a sale to new interests than a reorganization of existing interests.

(e) The "Sansome" rule does not apply to every transfer in reorganization. Surely it would not apply where transferor shareholders holding 99% received only cash supplied by new controlling interests and shareholders holding 1% received only transferee securities. It does not apply in a case like *Campbell,* where new cash paid out exceeded transferor earnings, nor in a case like the present where new cash paid out almost equaled combined transferor earnings, the cash being supplied by new controlling interests.

The Government's argument for remand contains ill considered statements. (Reply brief for petitioner, pp. 15-17). On pages 14 and 15 of its reply brief the Government agrees with our argument that the part of the 1928 cash distribution not properly chargeable

to capital account must be considered a distribution of earnings or profits. (Brief for the respondents, p. 12)

There is however no basis for the statement, "* * * but the record further establishes that Crandall had a large paid in surplus." There is no relationship between the purchaser's valuation of the purchased assets and the capital and surplus of Crandall. The Government should know by reference to the tax returns of Crandall in its possession that Crandall did not have "a large paid in surplus." If it were a fact that Crandall did have a large paid in surplus, this fact, so important to the Government's case, should have been included in the stipulation. Moreover, regardless of the number of shareholders who receive a distribution and regardless of whether or not the distribution is pro rata, every distribution by a corporation which has earnings, to any shareholder, in excess of the amount chargeable to capital, constitutes a distribution of the earnings and profits of the distributing corporation. (Revenue Act of 1928, Sec. 115, respondents' brief pp. 24-25) After so admitting earlier in its reply, the Government's argument on pages 15 to 17 of the reply leads only to confusion and should be disregarded. The effect of a preferential distribution on dividends paid credit under later laws should not be confused with its effect on earnings and profits.

Conclusion.

The main purpose of respondents' original brief was to demonstrate that the Tax Court decision and the Government's argument for transferred earnings *in toto* were wrong. Secondarily, we met the suggestion of the dissenting Judge below for segregation and remand by showing that the Tax Court must have considered and discarded the idea of transferred earnings in part. We therefore argued for affirmance because the Government had not sustained and could not sustain its position. The Government has admitted the error of the Tax Court's and its original position. It now urges the position of the dissenting Judge.

The position now urged by the Government does not relate to the question brought before this Court, namely, whether the "Sansome" rule requires treatment of predecessor earnings as successor earnings *in toto*. Moreover, on the question of application of the "Sansome" rule to the present case, we have demonstrated that the rule should not be extended to include part of the earnings in a single transaction which is more of the nature of a sale than of a reorganization.

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SUPREME COURT OF THE UNITED STATES

Nos. 674 and 675.—October Term, 1946.

Commissioner of Internal Revenue, Petitioner,		On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.
674	*v.*	
	Sidney S. Munter.	
Commissioner of Internal Revenue, Petitioner,		
675	*v.*	
	Carl Munter.	

[May 5, 1947.]

Mr. Justice Black delivered the opinion of the Court.

The Commissioner assessed deficiencies against respondents for failure to report as 1940 income dividends paid to them on stock of Crandall-McKenzie & Henderson, Inc., which respondents had bought earlier in that year.[1] These dividends are taxable as income to the respondents if the corporation paid them out of its earnings and profits. Int. Rev. Code §§ 22 (a), 115 (a), (b). Since its organization in 1928, the corporation had not accumulated earnings and profits sufficient to pay the 1940 dividend in full.[2] But the Commissioner found that the two old corporations which were merged in 1928 to form this new corporation had at that time, and turned over to the new corporation, accumulated earnings and profits suf-

[1] The Tax Court incorporated by reference a fact stipulation of the parties as its finding of fact. Each of the respondents had bought 10,000 shares of the 38,922 shares of the corporation then outstanding. The dividends declared in 1940 amounted to $35,166.25, of which each of the taxpayers received $12,500.

[2] At one point in the stipulation it was indicated that the new corporation had "no earnings and profits accumulated from December 4, 1928, to December 31, 1939," and no earnings or profits in the taxable year 1940. But elsewhere in the stipulation it appears there may have been some $32,000 earnings and profits accumulated between 1928 and 1940. The Tax Court apparently did not resolve these contradictory statements.

ficient to cover these dividends. One of these old corporations, L. Henderson & Sons, Inc., had about $75,000 in earnings and profits accumulated since 1913; the other, Crandall-McKenzie Company, had about $330,000. Liability of respondents for these deficiencies depends upon whether the new corporation acquired and retained a sufficient amount of these earnings and profits of its predecessors to cover the 1940 dividends.

The 1928 merger took place under the following circumstances. Stockholders of Henderson and certain stockholders of Crandall-McKenzie agreed together with a firm of underwriters to effect a merger of the two corporations into a new one. The underwriters agreed to buy for cash 52% of the stock of the new corporation for public sale. In execution of this agreement the new corporation was formed and acquired all the assets of Henderson and Crandall-McKenzie. The six stockholders of Henderson accepted stock in the new corporation as full payment for surrendering their old company stock. Holders of nearly one-half of the stock of old Crandall-McKenzie did not accept new corporation stock but were paid some $355,000 in cash for their old stock.[3] The other old Crandall-McKenzie stockholders were satisfied to accept only new corporation stock. When the reorganization was complete the new corporation stock had been distributed as follows: 14,607 shares to old Crandall-McKenzie stockholders, 9,524 shares to

[3] Some of the Crandall-McKenzie stockholders were paid $356.00 plus per share; others were paid $315.53 per share for identical stock.

A part of the old Crandall-McKenzie stock for which cash was paid was bought for $300,000 cash by one old Crandall-McKenzie stockholder from another while the reorganization was being transacted. The stockholder who made this purchase thereupon surrendered his original Crandall-McKenzie holdings, together with his recently purchased shares, to the new corporation in exchange for shares in the new corporation and $300,000 cash. We do not decide whether the sale from one old stockholder to another represents a transaction separate from the reorganization. Whatever may be the ultimate significance of this point, it does not affect the result we reach here.

old Henderson stockholders, and 25,869 shares to the general public through the participating underwriters.

The Tax Court found that there was a failure of proof that the earnings and profits of the old corporations had been distributed in 1928. Relying upon the rule of *Commissioner* v. *Sansome*, 60 F. 2d 931, which, for tax purposes, treats a reorganized corporation as but a continuation of its predecessors, the Tax Court determined that the new corporation acquired all the earnings and profits of its predecessors in 1928. Then, without analyzing the earnings and distribution history of the new corporation after its inception in 1928 and prior to the 1940 distribution, the Tax Court concluded that the new corporation's accumulated earnings and profits were sufficient in 1940 to make the questioned dividends taxable to respondents as income. 5 T. C. 108. The Circuit Court of Appeals for the Third Circuit reversed, 157 F. 2d 132, following its earlier decision in *Campbell* v. *United States*, 144 F. 2d 177, which had narrowly limited the *Sansome* rule. The theory of the *Campbell* decision, so far as relevant to the only question directly presented here, was that change in ownership brought about by the participation of new investors in the reorganization made the new corporation such an entirely different entity that it could not properly be called, even for tax purposes, a continuation of its predecessors.* Thus, it was concluded, earnings and profits of the predecessors were not acquired by the new corporation.

We granted certiorari because of an alleged conflict with the *Sansome* rule. — U. S. —. In the state of the record presented we find it necessary to decide no more than

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* There were two independent grounds for the decision in the *Campbell* case. One ground was that the earnings and profits of the predecessor corporation there had actually been distributed in the course of the reorganization. The Circuit Court of Appeals stated expressly that it did not rest its decision in the instant case on this theory.

whether the distinction of the *Sansome* rule made by the *Campbell* case is correct.

A basic principle of the income tax laws has long been that corporate earnings and profits should be taxed when they are distributed to the stockholders who own the distributing corporation. See Int. Rev. Code §§ 22, 115 (a), (b). The controlling revenue acts in question, however, exempt from taxation distributions of stock and money distributions, at least in part, made pursuant to a reorganization such as transpired here in 1928. See Revenue Act of 1928, § 112 (b), (c), (i) (1) (A); § 115 (c), (h), 45 Stat. 791, 816–818, 822–823. Thus unless those earnings and profits accumulated by the predecessor corporations and undistributed in this reorganization are deemed to have been acquired by the successor corporation and taxable upon distribution by it, they would escape the taxation which Congress intended. See § 112 (h), Revenue Act of 1928; *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641; *United States* v. *Kauffmann*, 62 F. 2d 1045.

In *Sansome* v. *Commissioner*, *supra*, it was held that implicit in the tax exemption of reorganization distributions was the understanding that the earnings and profits so exempt were acquired by the new corporation and were taxable as income to stockholders when subsequently distributed. Congress has repeatedly expressed its approval of the so-called *Sansome* rule as a correct interpretation of the purpose of the tax laws governing reorganizations.[5] And Congress has apparently been satisfied with Treasury Regulations which follow the *Sansome* doctrine.[6]

[5] The Senate Committee recommending adoption of § 115 (h) of the Revenue Act of 1936 cited the *Sansome* case with approval. It described the new section as not changing "existing law." The Committee recommended the amendment only "in the interest of greater clarity." S. Rep. No. 2156, 74th Cong., 2d Sess. (1936) 19. See also § 115 (h) Revenue Act 1938, 52 Stat. 447; H. R. Rep. 2894, 76th Cong., 3d Sess. (1940) 41; S. Rep. 2114, 76th Cong., 3d Sess. (1940) 25.

[6] U. S. Treas. Reg. 94, Art. 115–11 (1936); U. S. Treas. Reg. 103, § 19.115–11 (1940). See *Taft* v. *Commissioner*, 304 U. S. 351, 357;

Of course, when, as in the *Sansome* case, all the stockholders of the old corporation swap all their old stock for identical proportions of the new, there can be no doubt that the earnings and profits of the old have not been distributed and are passed on to the successor corporation. But if the predecessors' earnings and profits are not distributed in the course of the reorganization, they do not disappear simply because the successor corporation has some assets and owners in addition to those of the old corporation or corporations. See *Putnam* v. *United States*, 149 F. 2d 721, 726. The congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part. Insofar as accumulated earnings and profits have been distributed contemporaneously with the reorganization so as to become taxable to the distributees, they, of course, cannot be said to have been acquired by the successor corporation. But insofar as payments to the predecessor corporations or their stockholders do not actually represent taxable distributions of earnings and profits, those earnings and profits must be deemed to have become available for taxable distribution by the successor corporation.

It would be inappropriate for us to make the factual analysis of this record necessary to trace the earnings and profits involved in the 1928 reorganization in the absence of such a determination by the Tax Court and review by the Circuit Court of Appeals. See *Helvering* v. *Rankin*, 295 U. S. 123, 131–132; *Helvering* v. *Safe Deposit & Trust Co.*, 316 U. S. 56, 66–67; *Commissioner* v. *Scottish American Investment Co.*, 323 U. S. 119, 124. It might be that upon a full factual analysis the Tax Court would conclude that the new corporation acquired and had retained earnings and profits of Henderson sufficient to cover the 1940

Helvering v. *Winmill*, 305 U. S. 79, 83; *Douglas* v. *Commissioner*, 322 U. S. 275, 281–282; *Bochm* v. *Commissioner*, 326 U. S. 287, 291–292.

distribution. Or the Tax Court may find it necessary to make further analysis of the 1928 distributions to Crandall-McKenzie's old stockholders. In this connection it is urged that the cash paid for part of the Crandall-McKenzie stock in 1928 constituted a taxable distribution of some or all of the accumulated earnings and profits. The Tax Court, however, has previously declined to consider these cash payments as such a distribution of earnings and profits in the absence of proof that the recipients had been taxed for them. But even if it were proved that old Crandall-McKenzie stockholders had been so taxed, the face amount of that tax would not necessarily reflect the earnings and profits distribution they received. For example, part or all of their tax may have represented capital gain as distinguished from earnings and profits.[7] Or the distribution may be found to have constituted a liquidation under § 115 of the Revenue Act of 1928.[8] It may be necessary on remand, therefore, for the Tax Court to consider, in the light of §§ 112 (c) and 115 of the Revenue Act of 1928, how much, if any, of the 1928 cash distribution to Crandall-McKenzie stockholders represented earnings and profits deductible from the earnings and profits transferred to the new corporation available for the 1940 dividend payments.

The decision of the Circuit Court of Appeals is reversed with directions that the cause be remanded to the Tax Court for proceedings not inconsistent with this opinion.

So ordered.

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[7] Section 112 (c) (1) of the Revenue Act of 1928 provides in effect if a cash or property distribution is made in the course of a reorganization "then the gain, if any, to the recipient shall be recognized but in an amount not in excess of the sum of such money and the fair market value of the property." But § 112 (c) (2) makes taxable as dividend income that portion of the gain which represents the distributee's share of the distributing corporation's earnings and profits.

[8] Section 115 (c) of the Revenue Act of 1928 governs the taxability of distributions in liquidation.